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No. _____

SUPREME COURT, U.S.
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IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1993

HARRY H. MITCHELL, and
JUNE M. MITCHELL,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

HARRY H. MITCHELL, ESQ.
In Propria Persona
39-423 White Canyon Drive
Palm Desert, California 92260
(619) 340-9527

Attorney for Petitioner
June M. Mitchell

20 pp

Lorraine Mitchell Legal Briefs

732 E. WASHINGTON BOULEVARD
LOS ANGELES, CALIFORNIA 90021-3086
(213) 747-5631 • FAX (213) 747-5843

CONTENTS REPRODUCED FROM FURNISHED PRETYPED COPY

QUESTIONS PRESENTED

1. Whether Section 83 of the Internal Revenue Code, 26 U.S.C. Sec. 83, applies to the transfer of property from a corporate employer to a corporate employee if the property is not subject to a substantial risk of forfeiture, but has been transferred in connection with the performance of services.

2. Whether the Commissioner of Internal Revenue may assert that the 1973 purchase of a stock warrant by a corporate employee was a transaction within the scope of Section 83 of the Internal Revenue Code, where the assertion is first made in 1989 (16 years after the purchase) or whether such a claim is barred by the equitable doctrines of laches and estoppel (the 1973 tax year

having been kept open for reasons unrelated to the assertion of the Section 83 claim).

3. Whether Section 1.83-7 of the Income Tax Regulations, 26 CFR 1.83-7, is invalid, as inconsistent with Section 83(a) of the Internal Revenue Code, in that such regulation (a) ignores the provisions of Section 83(a) of the Internal Revenue Code requiring all Section 83 property to be taxed in the *first* year in which such property is transferable or is not subject to a substantial risk of forfeiture, whichever is applicable, and (b) provides that in the case of a stock warrant without a readily ascertainable fair market value at the time of grant, the taxable event may be deferred to a later year when the warrant is sold or

disposed of.

4. Whether a stock warrant which lacks a readily ascertainable fair market value when purchased by a corporate employee from his corporate employer is taxable under Section 83 of the Internal Revenue Code, notwithstanding the provision of Section 83(e)(3) of such code which excludes such a warrant from the scope of Section 83.

5. Whether under the clear error doctrine governing the review of a trial court's factual findings, an appellate court may affirm a trial court's factual finding which (a) is inconsistent with the weight of the evidence, and (b) reaches a conclusion not based on descernible logic.

LIST OF PARTIES

The only parties to this action are listed in the caption.

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COMMISSIONER OF INTERNAL REVENUE

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Harry H. and June M. Mitchell (the "Taxpayers") petition this Court for a writ of certiorari to review the judgment

of the Court of Appeals for the Ninth Circuit (the "Ninth Circuit") which was entered in this case on April 29, 1993.

OPINIONS BELOW

The opinion of the court of appeals has been classified by that court as "Not For Publication", and has therefore not been reported. It is set forth at Appendix A, *infra*, A-1 to A-5. The Memorandum Decision of the United States Tax Court (T.C. Memo. 1990-617) was entered on August 27, 1991. (App. B, *infra*, B-1 to B-69.) The opinion is unofficially reported at 60 T.C.M. (CCH) 1368.

JURISDICTION

The court of appeals entered judgment on April 29, 1993. (App. A, *infra*. A-1.) This Court has jurisdiction under

28 U.S.C. Section 1254(1).

STATUTORY PROVISIONS AND REGULATIONS INVOLVED

A. The pertinent provisions of Section 83 of the Internal Revenue Code[1] (26 U.S.C. Section 83) are set forth below:

"§83. Property transferred in connection with performance of services

(a) General rule.--If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of--

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will

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[1] Unless otherwise indicated, all statutory references herein are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended and in effect during the tax year in issue (1973).

never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property,

shall be included in the *gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.* The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of

forfeiture. (Emphasis added)[2]

* * *

B. The pertinent provisions of Section 1.83-7 of the Federal Income Tax Regulations (26 CFR 1.83-7), which provides that certain stock options and warrants shall be taxed in a year subsequent to the year of receipt, are as follows:

> Section 1.83-7
>
> **"Taxation of Nonqualified Stock Options.--**
>
> (a) In general. If there is granted to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services, an option to which Section 421 (relating generally to certain qualified and other options)

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[2] The full text of Section 83 is set forth at Appendix C-1 to C-11.

does not apply, Section 83(a) shall apply to such grant if the option has a readily ascertainable fair market value (determined in accordance with paragraph (b) of this section) at the time this option is granted. The person who performed such services realizes compensation upon such grant at the time and in the amount determined under Section 83(a). *If Section 83(a) does not apply to the grant of such an option because the option does not have a readily ascertainable fair market value at the time of grant, Section 83(a) and 83(b) shall apply at the time the option is exercised or otherwise disposed of, even though the fair market value of such option*

may have become readily ascertain able before such time.[3] (Emphasis added)

* * *

STATEMENT

Petitioner Harry H. Mitchell is currently a lawyer practicing in Palm Desert, California.[4]

In 1973[5] the Taxpayer was Chairman of the Board, Chief Executive Officer and a member of the Board of Directors of California Life Corporation ("CLC"), an

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[3] The full text of Section 1.83-7 is set forth in Appendix D-1 to D-7.

[4] June M. Mitchell is a party to this litigation by virtue of having filed joint income tax returns with Harry H. Mitchell during the year at issue. All of the facts involved, however, concern Harry H. Mitchell's employment, and only Harry H. Mitchell is therefore mentioned in this petition.

[5] The issues raised in this petition relate only to the Taxpayer's taxable year 1973. In the Tax Court and the Ninth

insurance holding company owning substantially all of the outstanding stock of the California Life Insurance Company of Los Angeles ("CLIC").

CLC faced bankruptcy in March of 1973. It needed over $3 million dollars to discharge a short-term debt. It did not have the funds. It therefore sought a loan from the financial community. The banks (particularly Wells Fargo Bank of California) and other institutions approached by CLC for a loan agreed to advance the necessary funds if the Taxpayer would *invest* approximately $100,000 of his own funds in CLC. The Tax Court found as a fact that "*the investors* and banks

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5 (continued) Circuit, issues involved in other taxable years of the Taxpayer, were litigated. Such issues are not included in this petition.

contacted by CLC felt that some kind of *"personal investment in CLC by petitioner was necessary before they would consider a loan"* (emphasis added). (App. B-1, *infra* B-6). The Taxpayer invested his *own funds*, purchasing in 1973, a stock warrant[6] from CLC for $103,500 in cash.(*Id. at B-7*) The necessary loan was then made by one of the investors (Wells Fargo Bank of California). CLC was able to avoid bankruptcy.

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[6] The warrant, *inter alia*, was not subject to any employer-imposed restrictions or conditions imposing a risk of forfeiture. It authorized the Taxpayer to purchase 90,000 shares of CLC stock at the price of $8.00 per share over a ten-year period. The warrant's *full enjoyment* by the Taxpayer was *in no way conditioned on the future performance of any services to CLC by the Taxpayer*. (Cf. Secs. 83(c)(1) and (2), App. C, *infra*, C-4 to C-11.) So far as the CLC imposed restrictions were concerned, the Taxpayer, *immediately after the receipt of the warrant*, could have sold it or left the employ of CLC, without in either case having breached the provisions of the warrant.

On July 27, 1987, the Internal Revenue Service (the "Service") issued a Notice of Deficiency to the Taxpayer. It asserted a deficiency of $109,383 against the Taxpayer for the year 1976. This claim grew out of a 1976 exchange between the Taxpayer and CLC, in which the Taxpayer received 90,000 shares of restricted CLC common stock in return for surrendering his warrant to CLC. The Service maintained during the 10-year field examination of the Taxpayer and the Appeals review (approximately four years) that the exchange was a Section 83 transaction, and that the Taxpayer had received the 90,000 shares of common stock in connection with his performance of service. The Taxpayer denied this claim. The Taxpayer and the Service were unable to agree on this issue. The Taxpayer accordingly peti-

tioned the Tax Court to determine the controversy.

In January 1989, shortly before the February 1989 trial of the Taxpayer's case, the attorney for the Commissioner changed the Commissioner's position with respect to the Taxpayer's warrant. In his view, the purchase of the warrant in 1973 was the Section 83 transaction, (not its exchange in 1976). The Service's case in the Tax Court was framed along these latter lines.[7]

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[7] It is notable that in the approximately ten years in which the Taxpayer's case was being reviewed in the field, and the almost four years in which the Appeals section of the Service was examining the field report, the Service never asserted that the 1973 warrant purchase was within the scope of Section 83. *The January 1989 decision of the Service's counsel* was the first time the Service advanced Section 83 applicability for the warrant purchase.

During the 16-year period from 1973 to 1989, the 1973 tax year had been kept open for reasons unrelated to the Section

The Tax Court's decision was entered on August 27, 1991. The court found for the Commissioner on all issues before it. As to the applicability of Section 83 to the 1973 warrant purchase (the primary issue here), the Tax Court concluded that the warrant was transferred to the Taxpayer in connection with the performance of services in order to ensure his continuing services as Chief Executive Officer of CLC in the future. The court based its conclusion on two sentences appearing in a corporate document *written three years after* the warrant purchase--the CLC 1976 proxy statement. The two sentence excerpt

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7 (continued) 83 applicability to that year. That the year may have been technically open, is irrelevant to the equitable issue discussed below in the Reasons section for granting this petition. In view of the circumstances, the Service should not deal with a taxpayer in this "catch-as-catch-can" manner.

is set forth at Appendix H and is discussed in the next section.[8]

In its unpublished decision affirming the tax court (App. A, *infra*, A-2 to

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[8] The two sentences are found in the early part of the Court's opinion (App. B, *infra*, B-7 to B-8). They are part of a discussion of the CLC financing which had taken place three years earlier, in 1973. The first sentence merely states that the 1973 Board believed it was important that the Taxpayer stay with the company and that this could best be accomplished by his becoming a substantial equity holder in CLC. The second sentence noted that the company's potential lenders (in 1973) were reluctant to lend to CLC unless the Taxpayer had a substantial equity interest in the company. These two sentences were obviously post-transectional hearsay and were entitled to little, if any, weight on the issue before the court. If they have any bearing on that issue (which was whether the warrant purchase was an investment or a Section 83 transfer), they obviously support the investment view. The intrinsic of a Section 83 transfer, as the next section reveals, is the fact that property received by an employee is tied to the employee's service to the corporate employer. The linking device is found in the restrictions placed on the securities (or other property). In contrast, if the

A-3), the Ninth Circuit upheld the tax court's decision in two sentences. (The fact that this opinion is unpublished has no bearing on whether this Court will entertain a petition for certiorari. *Commissioner v. McCoy, infra.*) It stated that the petitioners' appeal essentially contested only the tax court's factual findings and that such findings were to be affirmed for the reasons set forth in the tax court's Memorandum Decision (App. A, *Id.*)

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8 (continued) employee pays full market value for property (here a warrant), and the property is not encumbered by restrictions, the purchase is an investment not within the scope of Section 83. (See *Alves v. Commissioner*, 734 F.2d 478 (9th Cir. 1984)).

The tax court did not mention this aspect of the *Alves* case (by which it was bound), and also failed to discuss questions 3 and 4 listed in this petition. The tax court has no equitable jurisdiction (See *Commissioner v. McCoy*, 484 U.S. 3,7 (1987), 108 S.Ct. 217), and therefore did not deal with question 2.

The Ninth Circuit's opinion did not deal with any of the five questions presented to this Court. (Questions 1, 3 and 4 had also been presented to the tax court.) These five questions figured prominently in the Taxpayer's briefs submitted to the Ninth Circuit, and in the Taxpayer's oral argument before the court.

REASONS FOR GRANTING THE PETITION

1. Summary

There are three reasons why this petition should be granted:

(1) **Abuse of Discretion.** The Ninth Circuit's disposition of the tax court's Memorandum Decision is wrong and should not be permitted to stand. The Ninth Circuit affirmed on the ground that the Taxpayer was contesting "essentially" only the "tax court's factual findings"

(App. A, A-2) and that (by implication) such findings did not reflect clear error (*Id.*). This is not correct. The Taxpayer, in addition to factual questions, contested the tax court's decision on the five legal grounds listed in the form of questions at the beginning of this petition. These five questions were presented in the briefs submitted to the Ninth Circuit. The Taxpayer's entire oral argument in the Ninth Circuit was devoted to them. Any one of them standing alone, if answered in the Taxpayer's favor, would justify a decision for the Taxpayer. The Ninth Circuit did not treat any of these questions. (Its decision comes very close to overruling the Ninth Circuit's 1984 decision in *Alves v. Commissioner,*

infra. Since the Ninth Circuit panel was not sitting en banc, it had no authority to overrule the decision of a prior panel.)

(2) **Conflict Among the Federal Circuits**. The Ninth Circuit's decision, if allowed to stand, will create a conflict among the Federal Circuits in regard to the applicability of Section 83 to non-restricted property. At the present time there is no such conflict. There appears to be no federal appellate decision, and no regular tax court decision, which agrees with the Ninth Circuit's *Mitchell* panel that non-restricted property is subject to Section 83.[9] The

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[9] Justice Anthony Kennedy of this Court was a member of the 1984 three-judge panel which decided *Alves*.

leading case on this point is the Ninth Circuit's *Alves* decision in 1984. What, in reality, is the status of *Alves* now, both in and outside of the Ninth Circuit [10]? The tax bar will have to conclude that there is dissatisfaction with *Alves* in the Ninth Circuit if a panel will so blatantly ignore its conclusions. The Commissioner can be anticipated, in view of *Mitchell*, to press for Section 83 extension to non-restricted property, using the tax court decision and its unanimous affirmance by the Ninth Circuit.

The decision of the *Mitchell*

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[10] Four other federal circuits are in line with *Alves's* view on Section 83 applicability to restricted property. The cases are mentioned below.

panel will inevitably seriously impact corporate stock purchase plans for employees.[11] These plans are frequently drafted in such a way as to make an employee's purchase an vestment, and not a Section 83 transfer. But this now may not be possible under the facts of *Mitchell*. As long as *Mitchell* stands, it would seem to be clear that there is no meaningful distinction, for Section 83 purposes, between an investment purchase of securities (or other property) by an employee from his employer, and a Section 83 transfer of the property to the employee. The difference between the tax consequences of these two types of transactions is

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[11] See the recent article from the *Los Angeles Times* at App. G, discussed below.

enormous.

(3) **Estoppel and Laches.** This case has unique equity features. First, it deals with an attempt by the Commissioner of Internal Revenue to reach back 16 years and tax the Taxpayer with respect to his 1973 tax year. Second, the basis of the Commissioner's claim (applicability of Section 83 to non-restricted property) is new in the tax field and contrary to the law in the Ninth Circuit (where the Taxpayer resided) as announced in 1984 in the *Alves* case.

Neither of the two courts which has heard this case (the tax court and the Ninth Circuit) *has been willing even to discuss the relevance of Alves* to the Taxpayer's

position.[12]

As a result, the Taxpayer now finds himself financially ruined by the assessment which has been made against him in respect of this issue by the Internal Revenue Service.[13]

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[12] The legal points are discussed briefly below. This discussion is of course merely designed to give the Court a profile of what is involved in the questions, and how, in turn, each of these questions could result in a lower court's decision in favor of the Taxpayer if these issues had been confronted. The discussion does not in any way purport to represent a brief on these questions.

[13] On January 11, 1992 the Taxpayer was assessed $425,102 in back taxes and interest, attributable to the applicability of Section 83 to the 1973 warrant purchase. At current interest rates, this sum increases by over $37,000 per year. Additionally, the state of California has delivered a notice of assessment to the Taxpayer, for the above year and on the same ground as the internal Revenue Service, for approximately $21,000 (the California income tax statute is the same as the federal statute in this respect). These sums are far in excess of the Taxpayer's resources.

Only the United States Supreme Court can now deal with this complex and extraordinary problem. It is not in keeping with the American system of justice for inequities such as exist here to be without a remedy.[14]

Section 83 became part of the Internal Revenue Code in 1969. This Court has apparently not yet dealt with any of its principal provisions. The case involved in the present petition raises a most fundamental point regarding the applicability of Section 83, which (in view of *Mitchell*) should be considered by this court.

In *Mitchell* the Commissioner is attempting (thus far successfully) to

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[14] The equity doctrine of estoppel is discussed below. The Ninth Circuit declined to consider it.

extend the reach of the statute to non-restricted property--an area previously regarded as not within the purview of Section 83. This attempt, if unchecked, will create confusion and uncertainty in an important field of tax law. It will largely wipe out the ability of an employee to purchase stock (or other property) from his employer without subjecting the transaction to the Section 83 ordinary income taxation rules.

The *Mitchell* case affords the Court an excellent opportunity to express its views on that subject, making clear whether non-restricted property can properly be subject to this complex statute.

2. THE FIVE LEGAL ISSUES NOT DISCUSSED BY THE NINTH CIRCUIT

(a) SECTION 83 APPLIES ONLY TO RESTRICTED PROPERTY.

The 1973 warrant purchased by the

Taxpayer did not contain any employer-imposed restrictions regarding its transferability or forfeiture. The Commissioner's brief in the Ninth Circuit did not dispute this. So far as employer-imposed restrictions were concerned,[15] the Taxpayer could have sold the warrant ten minutes after he received it without breaching any of his obligations to the employer.

In view of the absence of any restrictions, it follows, under the Ninth Circuit's *Alves* decision, *supra*, that the

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[15] The term restricted, as used herein, applies to employer-imposed restrictions of the type described in the House and Senate Committee reports regarding Section 83 (see App. E and App. F). It does not refer to the concept of securities which are restricted by reason of not being registered under the Federal Securities Act of 1933. The hallmark of restricted property under Section 83 is the fact that it is subject to a substantial risk of forfeiture because of issuer-imposed restrictions.

warrant in *Mitchell* was not subject to Section 83. In *Alves* the Ninth Circuit, in dealing with the applicability of Section 83 said, at 734 F.2d, page 481:

> .... By its terms, the statute [§83] applies when property is (1) transferred in connection with the performance of services; (2) subject to a substantial risk of forfeiture; and (3) not disposed of in an arm's length transaction before the property becomes transferable or the risk of forfeiture is removed.[16]

Four other Federal courts of appeals

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[16] The *Alves* language quoted above was called to the Ninth Circuit's attention by the Taxpayer during the oral argument of the case at bar. The Taxpayer pointed out that, for Section 83 applicability to attach, the property in question had to pass the restricted property test as well as the performance of services requirements. (Since the property had not been disposed of, the third requisite of the *Alves* rule is not applicable in the *Mitchell* case.) (footnote continued on next page

are in line with *Alves* on Section 83 restricted property[17]. Moreover there is

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16 (continued) The *Alves* case contains an additional feature which is of relevance to *Mitchell*. The taxpayer in *Alves* had received (in addition to his restricted stock) certain stock referred to as "free" stock *which lacked restrictions*. The Commissioner had not tried to tax the sale of this stock, to which the Ninth Circuit raised no objection (in keeping with the above-cited rule). *Alves*, 734 F.2d at 480.

17 Eighth Circuit: *Bagley v. Commissioner*, 866 F.2d 169 (8th Cir. 1986, aff'g 85 T.C. 663 (1985) (restricted stock option granted in an employment agreement was transferred to taxpayer in consideration of his promise to render services as an employee).
Seventh Circuit: *Centel Communications Co. v. Commr.* 920 F.2d 1335 (7th Cir. 1990), aff'g 92 T.C. 612 (1989) (Section 83 applicability denied to shares received by stockholders who guaranteed the corporation-issuer's bank debt because the shares, while restricted, were *not* transferred in connection with the performance of services).
Sixth Circuit: *McNaughton v. U.S.*, 888 F.2d 418 (6th Cir. 1989) (restricted stock necessary for Section 83 applicability).
Fifth Circuit: *MontelPre Systemed, Inc. v. C.I.R.* (956 F.2d 496 (5th Cir. 1992) (right of first refusal regarding immovable property, which was subject to a substantial risk of forfeiture, was Section 83 property).

no known appellate case, or any regular tax court decision, which takes a different position. In fact there appears to be no case in which the issue posed here--whether Section 83 as a matter of law can apply to non-restricted property--is even discussed. The courts seek only to find the presence of restricted property. If it is present, Section 83 applies (absent other disqualifying factors).

The *Alves* rule is totally consistent with the legislative history of Section 83. That section was designed to bring the tax treatment of restricted stock plans into line with the treatment accorded similar deferred compensation arrangements. (*Alves, supra*, at 734 F.2d 481). A restricted stock plan is defined in both the House and Senate Reports[18] of the

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[18] It is noteworthy that each Report is captioned "Restricted Property".

91st Congress (which enacted Section 83) as "an arrangement under which an employer transfers stock to one or more of his employees ... *where the stock is subject to certain restrictions which affect its value*". (Tax Reform Act of 1969, 1969 U.S. Code Cong. & Ad. News, House Report at 1733, Senate Report at 2150, (Emphasis added) App. E, *infra*, E-1; and App. F, *infra*, at F-1 respectively.)

Finally, the Ninth Circuit's affirmance of the tax court here destroys the fundamental scheme of §83, in that it eliminates the obvious way in which the performance of services requirement is satisfied. The courts have made clear that there has to be a linkage between the performance of services and the transfer of the concerned property for Section 83 to apply. As *Alves* points out, that

linkage is supplied by the restrictions on the stock transferred. (*Alves, supra* at 734 F.2d 481). It is the restrictions which enable a corporate issuer to have appropriate assurance that the recipient employee will remain for a specified period in the service of his company. If the existence of restrictions on the transferred property is not to be a condition of Section 83 applicability, there is then no effective way in which a reviewing court can discern a linkage between the transfer of the property and the performance of services.

Indeed, the case before this Court in this petition is an excellent illustration of the above. As the Taxpayer pointed out in oral argument before the Ninth Circuit, he could have left CLC, *without breaching any obligations*, within ten minutes after he purchased the warrant

(taking the warrant with him). This condition makes a mockery of the tax court's conclusion in this case (App. B, *infra*, B-44 to B-45), in which the court stated that the warrant was transferred to the Taxpayer "in order to *assure* his continuing services as chief executive officer" (*emphasis added*). In reality, there was no assurance whatsoever: the Taxpayer could have left immediately upon his receipt of the warrant without any breach of his obligations. It is inexplicable that both the tax court and the Ninth Circuit could have reached such a conclusion.[19]

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[19] If the Ninth Circuit's disposition of Mitchell stands, one can expect in the future more factual findings regarding the performance of services to be based on the flimsy and unacceptable type of evidence represented in the two-sentence excerpt in the case at bar. Once the anchor of restricted property is deemed to be no

(b) **ESTOPPEL AND LACHES**

The warrant was purchased by the Taxpayer in 1973. The Taxpayer's return was carefully audited in the field over a 10-year period. The Service made no claim that Section 83 applied to the 1973 warrant purchase. The case was then almost four years in Appeals. No such claim was made there. It was not until January of 1989, shortly before the case was tried in the tax court, that the Service (i.e., an attorney in charge of a lawsuit, not a policy-making official) decided that a Section 83 claim should be brought against the warrant purchase in 1973. The Service based its claim, not on testimony or a

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19 (continued) longer necessary in this area, how can a court determine with any accuracy and consistency whether property was, in fact, transferred in connection with the performance of services?

document connected with the 1973 transaction, but rather on two sentences in a lengthy CLC proxy statement issued in 1976 (*three years after the purchase*) in connection with the stockholders meeting for that year.

This decision worked a great hardship on the Taxpayer. It was difficult for him to find witnesses with respect to the 1973 warrant purchase. It was particularly important to find a 1973 CLC corporate director who could corroborate the Taxpayer's own testimony *that, in the eyes of the 1973 CLC Board, the warrant purchase was an investment by the Taxpayer, not a Section 83 transfer.*[20] However,

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[20] This had to do with the intent of the 1973 corporate board in selling the warrant to the Taxpayer--a critical element in the performance-of-services test.

the 1973 board was widely scattered, addresses had been lost, and in one important case a former director was dead. The Taxpayer was therefore able to find only two witnesses who could testify on this point, and they had not been Board members. They resided in Milwaukee and Miami and were brought to Pasadena, California (where the tax court trial occurred) at substantial cost to the Taxpayer.

The facts here obviously suggest the relevance of estoppel and laches as a defense to the Commissioner's postion. Unfortunately, the tax court has no equity powers. (See *Commissioner v. McCoy, supra*, 484 U.S. 3, 7.) The estoppel argument could not be raised there. The Taxpayer brought the issue up, however, in the Ninth Circuit. The Ninth Circuit

ignored the matter, notwithstanding the considerable body of law in that Circuit regarding the point.[21]

The case of *Shuster v. Commissioner*[22], *infra*, is directly in point. In this case the Commissioner changed his position regarding the taxability of a trust corpus. Since the trustee bank, relying on the Commissioner's earlier determination that the corpus was not taxable, had already distributed the corpus to the beneficiary, any tax liability would have to be paid from the Bank's funds, and not from the corpus. In

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[21] See *Gaylord v. Commissioner*, 153 F.2d 408, 416 (9th Cir. 1946); *Van Antwerp v. U.S.*, 92 F.2d 871 (9th Cir. 1937); *U.S. v. S.F. Scott Sons, Inc.*, 69 F.2d 728 (1st Cir. 1934); and *Shuster v. Commissioner*, 312 F.2d 311, 317 (9th Cir. 1962).

[22] *Shuster*, although not in the Taxpayer's Ninth Circuit briefs, was submitted to the Court, in accordance with Ninth Circuit rules, before oral argument occurred.

applying the estoppel doctrine against the Commissioner on this issue, the court rejected the view that estoppel cannot be applied against the government[23]. The court said:

> It is conceivable that a person might sustain such a profound and unconscionable injury in reliance on the Commissioner's action as to require, in accordance with any sense of justice and fair play, that the Commissioner not be allowed to inflict the injury. It is to be emphasized that such situations must necessarily be rare, for the policy in favor of an efficient collection of the public revenue outweighs the

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[23] There was no serious laches issue in *Shuster*. Only a four year period appears to have elapsed between the original decision of the IRS and its later change of position. In *Mitchell*, there is the 16-year delay factor to consider.

> policy of the estoppel doctrine in its usual and customary context. But as long as the concept of estoppel retains any validity, it is conceivable that such situations might arise.**** It is our conclusion that the Bank's equitable interest is so compelling, and the loss which it would sustain so unwarrantable as to justify the application of the estoppel doctrine against the Commissioner. (*Shuster, id.*, at 312 F.2d at 317 and 318.

In the present case the Commissioner waited sixteen years before changing his mind regarding Section 83 applicability to the Taxpayer's 1973 warrant purchase. His change of position came after a ten year field audit and a four year appeals review had found no reason for a change. And his

about face (made by an attorney, not a policy official) was in a circuit governed by the *Alves* decision providing that Section 83 did not apply to non-restricted property.

It is respectfully suggested that the hardship of the trustee bank in *Shuster* is not greater than that of the Taxpayer.

C. TAXABLE EVENT: THE TAXABLE YEAR FOR THE 1973 WARRANT PURCHASE WAS 1973, NOT 1976

The tax court held that the taxable event with respect to the 1973 warrant purchase occurred, not in 1973, but in 1976 when the warrant was exchanged for 90,000 shares of CLC restricted common

stock. The Ninth Circuit affirmed without comment.

To support its conclusion, the tax court relied on Inc. Tax Reg. 1.83-7 (26 CFR 1.83-7), which provides that a nonstatutory option (or warrant) which does not have a readily ascertainable fair market value at the time of grant will be subject to tax when it is sold or disposed of, not when it is received by the grantee.

This regulation, so far as it applies to the Taxpayer's warrant purchase in the present case, is inconsistent with Section 83(a) and cannot be given effect. Section 83(a) requires that any property shall be taxed (according to the Section 83 tax formula) in the first taxable year in which the transferee becomes fully vested with respect to the property (i.e., in the first taxable year in which the rights of the person having the beneficial

interest in such property (here the Taxpayer) are transferable, or are not subject to a substantial risk of forfeiture, whichever is applicable).

Under this language, it is clear that the first taxable year for the Taxpayer's warrant was 1973. The Taxpayer's warrant, when acquired in 1973, was, so far as CLC restrictions were concerned, freely transferable and not subject to a substantive risk of forfeiture. *This would mean, however, that there would be no tax due.* The Section 83 tax formula provides that the taxable amount is the excess of the fair market value of the property over the amount paid for such property. The Taxpayer paid $103,500 in cash for the warrant (a stipulated fact). The tax court, however, in dealing with

the Taxpayer's Section 162(a) claim,[24] had concluded that the fair market value of the warrant when it was issued was $103,500. Thus if the clear wording of Section 83(a) had been followed, the taxing formula therein would have resulted in no tax.

There is no way in which the validity of Section 1.83-7 of the Income Tax Regulations can be sustained, in view of its direct clash with the text of Section 83(a).[25] (*Lykes v. U.S.*, 343 U.S. 118 (1952, 24 L. Ed.2d 92, 90 S. Ct. 104.)

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[24] This claim is discussed briefly below.

[25] Inc. Tax Reg. 1.83-7 clashes with Section 83 in another significant respect so far as its validity is concerned. It makes the fact that an option lacks a readily ascertainable fair market value the test of whether an option may be shunted to a future year for taxation purposes. Section 83(e)(3), however, provides that *Section 83 does not apply at all* to the transfer of an option which does not have a readily ascertainable fair

(d). SECTION 83(e)(3): THE WARRANT PURCHASED IN 1973 WAS NOT WITHIN THE SCOPE OF Section 83

Section 83(e)(3) provides that Section 83 does not apply to the "transfer of an option [or a warrant] without a readily ascertainable fair market value." The language is taken directly from the House and Senate Reports on Section 83, and the language of the respective Reports makes clear that the language means what it says (see House Report, *supra*, at App. E, E-13; Senate Report, *supra*, App. F, F-12.) The warrant purchased by the Taxpayer in 1973 was lengthy and complex. It would be absurd to assert that such a warrant had a readily ascertainable fair

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25 (continued) market value. This is standing the wording of Section 83 on its head. (See below).

market value when purchased. Indeed, the tax court itself concluded (in deciding that Section 1.83-7 required the shunt of the taxable event to 1976) that the Taxpayer's warrant did not have a readily ascertainable fair market value at the time of its purchase by the Taxpayer. (See, App. B, *infra* at B-51.)

Under these circumstances, it seems crystal clear that, regardless of the above considerations, the 1973 warrant purchase by the Taxpayer did not come within the scope of Section 83.

(e) CLEAR ERROR DOCTRINE: *COMMISSIONER V. DUBERSTEIN* (363 U.S. 278 (1960).

In its decision in *Mitchell*, the tax court made two critical factual findings: (1) it rested its conclusion regarding the 1973 applicability of Section 83 to the warrant purchase on two sentences (the two sentence excerpt) written three years

after the purchase, under the authority of a different CLC Board (the majority of whose members were not directors in 1973, when the warrant transaction occurred); and (2) it concluded that the fair market value of the warrant when purchased was $103,500 (equal to the purchase price), *notwithstanding* the fact that in reaching this conclusion it (i) wrongly stated (according to the overwhelming weight of the evidence) that CLC was not facing bankruptcy when the Taxpayer agreed to purchase the warrant (imminent bankruptcy would have depressed the warrant's value), and (ii) arbitrarily increased the $30,000 valuation attributed to the warrant by the Taxpayer's expert witness to $103,500 (a 345% increase) without providing any reason for the increase other than its own "feel" that a higher price was warranted (App. B, B-31).

The so-called "two sentence excerpt" has been discussed above. It is set forth in full *infra*, at App. H. It is a post transactional hearsay statement. It has virtually no evidentiary value at all. The trial court, however, without any discussion of the substantial body of evidence of the Taxpayer arguing for an investment finding, concluded, *on the above evidence alone*, that the warrant was transferred to the Taxpayer in connection with the performance of services. This questionable conclusion led directly to the crushing assessment of almost $500,000 which the Taxpayer has received from the Service (see above).

The evidentiary support for the $103,500 finding for the 1973 fair market value of the warrant rests on similarly unsupportable evidence. The trial court

simply concluded that $30,000 was too low a value and, without any evidence, increased the value approximately 3 1/2 times.[26]

The Ninth Circuit affirmance of course put the Ninth Circuit's stamp of approval on both of these findings.

This Court's *Duberstein* opinion would clearly seem to require rejection by a appellate court of each of these two findings. If an appellate court, looking at the "entire evidence", reaches the "definite and firm conviction that a mistake has been committed", the finding under review must be viewed as "clearly

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[26] This increase was presumably necessary to the trial court's decision regarding Section 83 applicability. Section 83 contemplates that purchasers will usually pay less than the market value of transferred property, with the difference taxable at ordinary rates. The notion that a transferee could be found who would pay more than the value of the transferred property, and then be obligated to render

erroneous". (*Duberstein supra*, at 363 U.S. 291). It is inconceivable that a reasonable application of the *Duberstein* rule would permit these two factual findings to stand with all their critical conconsequences to a taxpayer.

The Sixth Circuit would apparently view these two findings rather differently. See *Miami Valley Broadcasting Corp. v. CIR*, 594 F.2d 556 (6th Cir. 1979); and *Akers v. Commissioner*, 798 F.2d 894 (6th Cir. 1986).[27] Both these cases involved the review of tax court valuations. In these two decisions, the Sixth Circuit pointed out that while the applicable "standard of review requires that we

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26 (continued) services in the future, verges on the ludicrous. To avoid this situation, the trial court found that the market value of the warrant was equal to its purchase price, but it clearly found it difficult to justify such a market value.

27 *Akers* was submitted by the Taxpayer to the Ninth Circuit before the oral argument.

accord great deference to the values established by the tax court ... *it does not render us a mere rubber stamp (Miami Broadcasting, supra*, at 594 F.2d 557).(Emphasis Added). *Akers*, the more recent case, repeated the rubber stamp doctrine, and added that the tax court's valuation judgments must exhibit a "discernible logic" (*Akers, supra*, at 798 F.2d 897). In both cases, the tax court's valuations were rejected.

Miami Broadcasting and *Akers* are a far cry from the Ninth Circuit's extremely deferential treatment of the two above items in *Mitchell*. The tax court's decision regarding the two sentence excerpt and fair market value could not possibly pass the "no discernible logic" and "no rubber stamp" tests of the Sixth Circuit.

This Court now has an excellent opportunity to review the two 1973 factual

findings in *Mitchell* and clarify the *Duberstein* rule in the light of the two Sixth Circuit decisions. It would seem that an excessive degree of deference has crept into the Ninth Circuit's review of tax court findings.

3. **Remand**

If for any reason this Court concludes that the petition for certiorari in this case should be denied, it is respectfully urged that this case be remanded, under 28 U.S.C. Sec. 2106, to the Ninth Circuit for further proceedings to determine the Section 83 and other legal issues involved in the Taxpayer's 1973 tax year, as set forth in the Questions Presented section of this petition.

Remand is a well-known method utilized by this Court to require a lower court to consider an issue which should have been (but was not) dealt with by the

court below. See *Bivens v. Six Unknown Named Agents of Federal Bureau of Narcotics*, 403 U.S. 388, 29 L. Ed.2d 619 (1971), (on remand) 456 F.2d 1339 (2nd Cir. 1972)

Remand (if certiorari is not granted) is quite appropriate here. The Taxpayer has received virtually a $500,000 assessment from the Internal Revenue Service, far in excess of his ability to pay. The discussion in this petition reveals that there is at the least grave doubt as to whether this assessment was in accordance with law, since the tax court did not address pertinent and material legal questions. The questions were presented to the Ninth Circuit. The Ninth Circuit panel, in an extraordinary abuse of its discretion, ignored these questions (to which the panel's attention had been called by the Taxpayer in his brief and in oral argument), affirming the tax court's

decision on the ground that only factual issues were involved in the lower court's decision (which was manifestly incorrect) and that such factual findings were without clear error.

The Taxpayer is unaware of any precedent for this situation. The interests of the administration of justice in the United States would seem to require that, before the Internal Revenue Service moves to collect all of the Taxpayer's assets, there should be a judicial examination of the basic legal questions applicable to this $500,000 assessment.

4. **Effect on the Nation's Taxpayers**

This point has been mentioned briefly above, where it was noted that the elimination, for practical purposes, of the right of an employee to invest in his corporation's stock (which is essentially involved here) would adversely affect many

taxpayers who might wish to make such investments. It should be realized that if *Mitchell* is unreversed, many taxpayers who have made such purchases, believing them to be investments, may now be vulnerable to Service claims that their purchases are Section 83 transactions. The tax years 1990-1992 are still open (the three-year statute of limitations not yet having run for 1990), and the Service has ample time in which to register such claims.

The effect on future stock (or other property) transactions between employers and employees is potentially most severe. Stock ownership by employees has long been considered by corporate boards to be desirable for stockholders. In view of *Mitchell* employee stock ownership is now a perilous undertaking for a stockholder. It is difficult to see how a corporate stock ownership plan can be crafted which places

stock in an employee's hands without creating a Section 83 transfer. In the past, a plan which made such stock wholly free of issuer-imposed restrictions and required the employee to pay full market value for the stock could generally be regarded as without the scope of Section 83. Since the Ninth Circuit's disposition of *Mitchell*, there is no longer any certainty in such matter.

In an article on May 5, 1993, the *Los Angeles Time* pointed out that major U.S. corporations (Campbell Soup, Eastman Kodak Co., and Chrysler Corporation) appear to be considering the introduction of executive stock ownership plans, under which corporate officers would acquire ownership of substantial shares in their respective corporation. Corporate officers might be required to buy and hold shares having a value of two or three

times their annual salary (App. G). The question that arises, of course, is whether the purchase of these shares would be within the scope of Section 83. In view of *Mitchell*, they could be.

This Court now has an excellent opportunity to grant certiorari in *Mitchell* and clarify the question of Section 83 applicability--considering both (a) whether Section 83 applies to non-restricted stock, and (b) if Section 83 can be construed to apply to unrestricted property (the Mitchell panel's view) what are the standards that the performance-of-services requirement must meet?

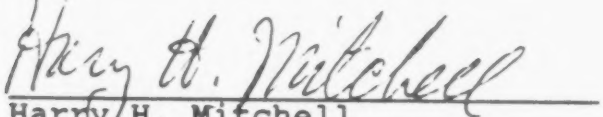
CONCLUSION

The petition for a writ of certiorari should be granted.

In the event that this Court should conclude that the petition for certiorari should not be granted, it is respectfully

urged that the Court remand this case to the Court of Appeals for the Ninth Circuit, with instructions to consider the above-cited legal questions relating to the Taxpayer's 1973 tax year.

Respectfully submitted,



Harry H. Mitchell
In Propria Persona
Attorney for June M. Mitchell

June, 1993

APPENDIX A

APPENDIX A

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

HARRY H. MITCHELL; JUNE M. MITCHELL,	)	No. 91-70706
	)	Tax Ct. No. 31051-87
Petitioners-Appellants,	)	
	)	**MEMORANDUM***
vs.	)	
	)	
COMMISSIONER INTERNAL REVENUE SERVICE,	)	
Respondent-Appellee.	)	
	)	

Appeal from a Decision of the United States Tax Court

Argued and submitted April 5, 1993
Pasadena, California

Before: J. Clifford Wallace, Chief Judge
Diarmuid F. O'Scannlain and Ferdinand F. Fernandez, Circuit Judges

Harry H. Mitchell and June M. Mitchell, husband and wife, appeal the tax court's judgment following a trial in which the tax

* This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by 9th Cir. R. 36-3.

court upheld the Commissioner's deficiency determinations for the Mitchells' 1973, 1976, and 1980 tax returns. The tax court found that: (1) Mr. Mitchell's purchase of a stock warrant was a nondeductible capital expenditure, not a deductible business expense, under 26 U.S.C. § 162; (2) He was required to recognize a gain upon his transfer of the stock warrant, in accordance with 26 U.S.C. § 83; and (3) He was not permitted to exclude from income damages that he received from his former employer, under 26 U.S.C. § 104. (A fourth determination concerning net operating loses was not appealed.)

The Mitchells' appeal essentially contests the tax court's factual findings. Although we do review issues of law de novo, we review factual determinations, and inferences from those facts, for clear error. See Vukasovich, Inc. v. Commission-

er, 790 F.2d 1409, 1411-13 (9th Cir. 1986). We have carefully reviewed the record and the tax court determination, and we affirm for the reasons set forth in that court's memorandum decision filed December 6, 1990, 60 T.C.M. (CCH) 1368 (1990).

The Mitchells now also assert that the 1976 exchange was a nontaxable reorganization under 26 U.S.C. §§ 354 and 368. The tax court did not reach that issue. We agree with the Commissioner that the Mitchells waived the issue on appeal by not effectively raising the issue in the tax court. It was not mentioned in their petitions or at the trial itself. In their opening brief following the trial, the Mitchells alluded to the fact that the transaction "could have been" a tax free exchange, but said that they were not going to discuss the question. That two sentence allusion was in the midst of a 96 page

brief. Then in their simultaneous reply brief they did decide to devote nine pages to a discussion of the issue.

The tax court will not consider an issue which is raised for the first time in a brief, if surprise or prejudice is found to exist. E.g., Seligman v. Commissioner, 84 T.C. 191, 198 (1985), aff'd, 796 F.2d 116 (5th Cir. 1986). It is apparent that surprise and prejudice do exist where a party has eschewed presentation of an argument on an arcane issue like corporate reorganization, and then springs that argument on the other side in a reply brief. The taxpayers respond to this by pointing to some passing references in a letter sent to the Commissioner five years before the trial started. Given the posture of this case, we do not doubt that the tax court failed to address the issue because it deemed it waived. We therefore

decline to consider it. See Richmark Corp. v. Timber Falling Consultants, 959 F.2d 1468, 1473 (9th Cir.) (failure to raise issue in district court waived issue on appeal), cert. dismissed, 113 S. Ct. 454, 121 L. ed 2d 325 (1992).

AFFIRMED.

APPENDIX B

APPENDIX B

T. C. Memo. 1990-617

UNITED STATES TAX COURT

HARRY H. MITCHELL AND JUNE H. MITCHELL, Petitioners v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 31051-87.

Filed December 6, 1990.

Bruce I. Hochman, Jerome A. Busch and Harry H. Mitchell, for the petitioners.

Charles O. Cobb and Richard Stack, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WRIGHT, Judge: Respondent determined the following deficiencies in petitioners' Federal income tax:

Served Dec. 6. 1990

		Additions to Tax
Year	Deficiency	Sec. 6653(a)[1]
1973	$ 33,577	$1,679
1974	$ 26,337	$1,317
1975	$ 10,146	---
1976	$109,383	---
1977	$ 4,193	---
1978	$ 25,831	---
1980	$ 16,244	---

After concessions by both parties, the remaining issues for decision are: (1) whether petitioners are entitled to a business expense deduction in taxable year 1973 for a portion of the purchase

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[1]All section references are to the Internal Revenue Code of 1954, as amended and in effect for the years at issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

price of a stock warrant; (2) whether petitioners must recognize income as determined by respondent in taxable year 1976 due to the exchange of such warrant for stock; (3) whether amounts received by petitioner Harry H. Mitchell in taxable year 1980 in connection with the settlement of litigation are excludable from gross income under section 104(a)(2); (4) whether the Leslie Investment Company, which is owned by petitioners and their children, is entitled to carry back a net operating loss incurred in taxable year 1981, a year in which the company was a subchapter C corporation, to taxable year 1980, a year in which the corporation was a subchapter S corporation.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipula-

tion of facts and the accompanying exhibits are incorporated herein.

I. Warrant Issues

Petitioners resided in Palm Desert, California, when they filed their petition. In 1970, petitioner became the chief executive officer, and, in 1971, chairman of the board of directors, of the California Life Corporation (hereinafter referred to as CLC) and the California Life Insurance Company (hereinafter referred to as CLIC). CLIC was CLC's principal operating subsidiary. The outstanding stock of CLC was listed on the American Stock Exchange. There were approximately 1,000,000 shares of its common stock outstanding from January of 1973 through May of 1976.

In June of 1972, CLC acquired individual and group life insurance (hereinafter referred to as the ITT Hamilton in-

surance) in the face amount of $9,380,000 from ITT Hamilton Life Insurance Company of St. Louis (hereinafter referred to as "ITT Hamilton") for $9,336,001. A cash payment of $600,210 was made to ITT Hamilton by CLC in June. The remainder of the purchase price was discharged through long-term borrowings of $5,000,000 and execution of a short-term note payable to ITT Hamilton for $3,735,791. The short-term note was due on December 31, 1972, but was extended at the request of CLC to March 31, 1973. ITT Hamilton informed CLC that no further extensions should be expected.

CLC would risk losing the ITT Hamilton insurance if external financing was not arranged with which to repay the ITT Hamilton note by March 31, 1973. As a result, CLC intensified discussions with institutional investors and lenders,

seeking an investment or loan large enough to pay off the note due to ITT Hamilton. However, the investors and banks contacted by CLC felt that some kind of personal investment in CLC by petitioner was necessary before they would consider a loan. The investors and banks considered it critical to assure ongoing, professional management of CLC's insurance operations before committing funds to CLC. An employment contract and related restricted stock options were not regarded as sufficient to bind petitioner to CLC.

A. Issuance of the Warrant

On February 16, 1973, CLC offered petitioner a warrant (hereinafter referred to as the warrant) to purchase 90,000 shares of CLC common stock for $8 per share, such warrant to be exercisable for 10 years from the date of its is-

suance. The purchase price for the warrant, $103,500, was paid by petitioner from his own funds on March 17, 1973.

The warrant required that it and shares received upon its exercise be stamped or otherwise imprinted with a legend substantially in the following form:

> Neither this warrant nor the shares of Common Stock issuable upon exercise of the warrant have been registered under the Securities Act of 1933, and thus cannot be exercised, sold or transferred, and the shares of Common Stock issuable upon exercise of this warrant cannot be sold or transferred, unless they are so registered or unless an exemption is then available.

The warrant also contained anti-dilu-

tion provisions. In the case of issuance by CLC of additional common stock or securities convertible into common shares for a price less than the exercise price of the warrantor the stock exchange price of the stock, adjustments to the warrant would be made reducing the purchase price of the shares subject to the warrant and increasing the number of shares available for purchase. On CLC's 1973 financial statement, the $103,500 paid by petitioner for the warrant was credited to paid-in capital. Warrants to purchase CLC stock such as the one issued to petitioner were not actively traded on an established market during the years at issue.

The reasons for the issuance of the warrant to petitioner were described in a 1976 proxy statement of CLC as follows:

> At the time of the refinancing the Board of Directors determined that

in order to assimilate the business obtained from ITT Hamilton and continue the restructuring of the Company began in 1971, it was vital that Mitchell continue to serve as the Chief Executive Officer of the Company, and that this would best be accomplished by his expectation of becoming a substantial equity holder in the relatively near future. In addition, the Company's outside financial advisors, and potential investors approached with respect to the refinancing, were reluctant to finance or invest in the Company unless it was apparent that Mitchell's continued association was, as far as possible, assured by his ownership of a substantial equity-based interest in the Company.

The balance of the purchase price of the ITT Hamilton insurance was refinanced in February of 1973. Part of the funds came from the sale by CLC of one of its subsidiaries. The rest ($6,750,000) was borrowed from the Wells Fargo Bank on February 16, 1973.

During 1972, closing prices on the American Stock Exchange for the stock of CLC ranged from a high of $3.50, to a low of $1.50. In December of 1972 there was a reverse split of 1-for-5. The price of the stock immediately rose to $11 per share and a few public sales were recorded at a high of $11.50. During February and March of 1973, closing prices for the stock of CLC ranged from $8.75 to $7.12. On February 16, 1973, the day petitioner was offered the warrant, the closing price of CLC stock was $8.50. On March 27, 1973, the day petitioner purchased

the warrant, the closing price was $7.50.

Over the succeeding years the price of CLC stock declined. During this period the high and low closing prices for CLC stock were as follows:

Year	High	Low
1973	9-3/8th	2-1/4th
1974	4-1/2th	1-7/8th
1975	3-5/8th	2-3/8th
1976	5	2-5/8th

B. Exchange of the Warrant

As of February 13, 1976 the warrant had not been exercised in whole or in part. On February 13, 1976, petitioner and CLC entered into an agreement to exchange the warrant for 90,000 shares of unregistered CLC common stock. The proposed transaction was set for approval at a meeting of shareholders scheduled for May 21, 1976. The proxy statement issued by the board of directors for this

meeting summarized the reasons for the exchange as follows:

> the Board of Directors believes that the Company has made substantial progress in implementing the program of restructuring and development begun in 1971. It believes that this progress is largely attributable to the efforts of Harry H. Mitchell ("Mitchell"), who became a director and the Chief Executive Officer of the Company in 1970 and Chairman of the Board of Directors in 1971. Furthermore, the Board continues to believe that it is in the best interest of the Company to be assured, insofar as possible, that Mitchell devote his efforts to the Company's program of growth and development. In 1973, the Board of Directors determined that this assurance could best be secured by providing

Mitchell with an immediate and substantial equity interest in the Company. However, the Warrant to purchase up to 90,000 shares of the Company's Common Stock (a copy of which is attached as Exhibit C to this Proxy Statement) issued to Mitchell in 1973 for a cash price of $103,500 as the vehicle to effect this equity position has proven, in view of the Board, to be an unsuitable method of providing this interest. This unsuitability arises because, among other things, the unforeseen depression in the market price of the Company's Common Stock has (1) made its exercise in the relatively near future most unlikely, and (2) brought into consideration anti-dilution provisions which pose a substantial problem for the Company in light of its announced policy of

aggressive expansion through appropriate acquisitions and external growth.

Therefore, on February 13, 1976, the Company agreed with Mitchell, subject to approval by the shareholders as described in this Proxy Statement (1) to cancel the Warrant to purchase 90,000 shares of the Company's Common Stock and all of the rights pertaining thereto (including all anti-dilution and registration rights relating to future issuance of securities, as described below, and (2) in consideration therefore and in order to provide Mitchell with a more appropriate and immediate equity interest in the Company, to issue to him 90,000 shares of the Company's Common Stock (before adjustment for the 4-for-3 stock split described

above).

The proposed exchange was approved and took place on May 21, 1976. Immediately after the transaction, CLC's common stock was split 4-for-3, so that petitioner held 120,000 shares.

During the first three months of 1976, the closing price of CLC stock on the American Stock Exchange ranged from $2.75 to $5.00. On May 21, 1976, the date the exchange was approved and took place, the average price of the common stock of CLC on the American Stock Exchange was $4.375. The value of the 90,000 shares of stock received by petitioner on May 21, 1976, was $393,750, not taking into account its lack of registration, and $287,437.50, taking into account its lack of registration. Petitioners did not report any gain in connection with the acquisition or disposition of the warrant

on their 1973 or 1976 Federal income tax returns.

CLC and CLIC earnings declined after 1977 and there were increasing losses through 1982. In 1983, CLC was merged into a company owned by a third party. The common shareholders of CLC, including petitioner, received $0.35 per share in the merger. In 1986 the California Insurance Department took possession of CLIC under its statutory powers on the ground that CLIC was insolvent.

II. Exclusion From Gross Income Under Section 104(a)(2)

On April 21, 1978, petitioner entered into a new employment agreement with CLC and CLIC. The agreement provided for salary payments in an amount of not less than $125,000 per year for a term of 7 years. The agreement also provided for additional compensation of $12,500 per

year for a period of 20 years, payable to petitioner or his beneficiary. Under the terms of the agreement, petitioner's employment could be terminated on breach by petitioner of his obligations.

On May 12, 1979, following a dispute regarding CLC's 1978 financial statement and Form 10K, the board of directors removed petitioner from his position as chief executive officer of CLC. On May 19, 1979, he was removed from his position as chief executive officer of CLIC. Six weeks later, he was removed from his position as chairman of the board of directors. CLC and CLIC ceased paying petitioner his salary under his employment agreement on June 30, 1979.

In 1979, a stockholders' suit was filed against CLC, CLIC, and various corporate officers, including petitioner, alleging securities act violations,

conspiracy to falsify financial records, and breach of contract. The lawsuits were consolidated into an action before the United States District Court for the Central District of California titled In Re California Life Securities Litigation, Multi District Litigation No. 400. The consolidated action was commonly referred to as the "MDL No. 400 litigation."

On November 13, 1979, petitioner filed an action in the Superior Court of the State of California for the County of Los Angeles, titled Mitchell v. California Life Corporation, No. C 304161, requesting declaratory relief as to his rights under the 1978 employment agreement.

On June 18, 1980, petitioner filed an action in the Superior Court titled Mitchell v. California Life Corporation, No. C 326694, accusing CLC, its board of directors, and certain employees and

directors of CLC, of libel, slander, and conspiracy. The action was never served on any of the named defendants. The board of directors of CLC never discussed the action, and CLC's chief executive officer considered it frivolous.

On September 12, 1980, petitioner met with Timothy F. Kennedy, who was counsel for CLC. The meeting was for the purpose of entering into negotiations for the settlement of outstanding lawsuits between Mitchell and CLC. At the meeting petitioner delivered to Kennedy a document titled "Principles of Settlement" which stated that petitioner would settle all claims and litigation with CLC and CLIC provided they accepted all of the principles. The Principles of Settlement provides that "of the three payments of $50,000 mentioned in paragraph 1, $100,000 will be deemed to be in settle-

ment of employee's lawsuit against CLC, CLIC and various officers and directors for compensatory damages for slander and libel ***." The Principles of Settlement was not signed by Kennedy or any of CLC's officers, and was not approved by its board of directors.

By letter dated September 15, 1980, Kennedy notified petitioner that the Principles of Settlement for settling all claims between petitioner and CLC was acceptable to CLC, but that petitioner must become a settling defendant in the MDL 400 litigation and must also cooperate with CLC in any pending or future litigation. The letter does not specifically address the libel and slander action. On September 15, 1980, petitioner appeared before the United States District Court for the Central District of California and notified the

court that he would become a settling defendant in the MDL 400 litigation.

On September 22, 1980, petitioner and CLC executed a settlement agreement. The settlement agreement consisted of several documents, including a Memorandum of Understanding, a Revised Restricted Stock Agreement, a Release, and an Amended Employment Agreement. The libel and slander action was not a consideration of CLC in executing the settlement agreement.

The Memorandum of Understanding referred to the other documents and provided, among other things, that all pending litigation between the parties would be dismissed with prejudice. The only exception was the Superior Court action brought by petitioner with respect to his employment agreement. The Memorandum of Understanding provided that with respect

to this action dismissal with prejudice would not be entered until the parties fully performed their respective obligations under the Memorandum of Understanding, the Revised Restricted Stock Agreement, and the Amended Employment Agreement.

Paragraph 1 of the Amended Employment Agreement provided that the 1978 Employment Agreement between petitioner and CLC would be canceled. Paragraph 2 provided, among other things, that petitioner would agree to act as a consultant to the company. Paragraph 3 of the Amended Employment Agreement provided as follows:

> Unless the Agreement shall be terminated by the Company by reason of a Termination Event, as such term is defined in Section 4 below, Mitchell shall receive total compensation hereunder of $192,511, payable as

follows:

(a) on September 30, 1980, the sum of $50,511;

(b) on December 1, 1980, the sum of $50,000;

(c) on June 30, 1981, the sum of $50,000; and

(d) in addition to the forgoing, on the first day of each month commencing the first day of January 1, 1981, and continuing to and including February 1, 1982, the sum of $3,000. The payments referred to in subparagraph (b) and (c) above shall be deemed due on September 30, 1980, but at the election of the Company may be deferred, without payment of interest, to the dates set forth above. Such payments represent a full discharge of such payments owing to Mitchell under the Original Employment Agreement.

The agreement was terminable on a variety of grounds, including breach by petitioner of any part of the settlement agreement.

The libel, slander, and conspiracy action was dismissed by petitioner with prejudice on October 1, 1980. The declaratory relief action relating to petitioner's employment agreement was dismissed without prejudice on the same date. The first two payments called for by the Amended Employment Agreement were made to petitioner before the end of 1980. CLC and CLIC issued petitioner a Form W-2 reflecting the full $100,511 in payments as "wages, tips, or other compensation". Federal income tax and FICA tax were withheld. Petitioner reported the payment of $50,511 as wage income on

his 1980 Federal tax return.[2] The remaining payment of $50,000 was excluded from income. The third payment of $50,000 due to petitioner on or before June 30, 1981, was never made. In April of 1981, CLC informed petitioner that he was in default, and that CLC was terminating the agreement.

On August 13, 1981, petitioner filed an action in the Superior Court titled Mitchell v. Monge, No. C 378525, in which he alleged breach of the Amended Employment Agreement. In the pleadings and

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[2]Though petitioner reported the initial payment of $50,511 as compensation on his 1980 Federal income tax return, petitioner now argues that both payments made in 1980, totaling $100,511, are excludable from gross income under section 104(a)(2).

motions filed by petitioner in the Mitchell v. Monge action, petitioner described the Amended Employment Agreement and negotiations leading up to the Amended Employment Agreement as follows:

> The said $50,000 payment is to be made in partial discharge of payments owing the plaintiff under the original Employment Agreement of April 21, 1978
>
> ***
>
> The Agreement of September 22, 1980, was an employment agreement between plaintiff, on the one hand and CLC and CLIC (severally), on the other hand, and each of them.
>
> In return for signing such an agreement, Mitchell would receive in full settlement of the six-year period remaining on his employment contract (from mid 1979 to mid 1985), the sum

of $150,000, payable in installments over a nine-month period, and $3,000 per month as an employee/consultant of CLC.

III. Net Operating Loss Carry Back

Leslie Investment Corporation (Leslie) was a corporation formed by petitioner in 1980. During 1980 and 1981, the stock of Leslie was owned 98.7 percent by petitioners and 1.3 percent by their minor children. The assets of the corporation consisted of real property, a proprietary lease, and a limited partnership interest in a dairy operation.

In 1980, Leslie was an electing small business corporation under subchapter S. In 1981, Leslie revoked its subchapter S election and became a subchapter C corporation. The Form 1120 filed by Leslie for that year reported a loss of $12,320.

In an amended return for 1980, peti-

tioners sought to carry back the 1981 net operating loss of Leslie to Leslie's 1980 taxable year, and to pass through its share of the loss to petitioners' 1980 Federal income tax return.

OPINION

I. Business Expense Deduction

Section 162(a) provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Petitioner argues that the purchase of the warrant in 1973 for $103,500 was an ordinary and necessary business expense under section 162(a) incurred in carrying on his trade or business of being an employee, entitling petitioner to a deduction to be measured by the amount of the premium over market value paid for the warrant. Respondent argues that:

(1) petitioner has failed to prove that he paid a premium for the warrant; (2) petitioner has failed to prove that any such premium would be an ordinary and necessary business expense; and (3) the purchase of the warrant was a non-deductible capital expenditure for which any loss must be claimed upon realization.

A. Fair Market Value of the Warrant

We conclude that petitioner did not pay a premium over fair market value for the warrant. Petitioner's expert witness, Robert F. Howard, testified and submitted an appraisal report concluding that the value of the warrant as of March 27, 1973, was $30,000. Respondent contends that the warrant was worth at least $103,500, its purchase price. In valuing the warrant, Howard relied primarily on the future anticipated performance of CLC's common stock. He reasoned that "To

attempt to value the Warrant by relating it to the then market price of the Company's common stock or by comparing the ratio of publicly traded warrants to their respective stock prices and relating back to the Company, is not, in our opinion applicable in this particular case."

Howard began with an estimated midpoint of CLC's common stock of $4.76 - $4.96 per share as of December 31, 1973, and then estimated the future performance of the stock over the next ten years. From these estimates Howard estimated the value of the warrant itself. Howard also took into account his opinion that CLC was "on the verge of bankruptcy."

We find Howard's testimony and appraisal unpersuasive due to his failure to take into account the fact that on the day petitioner was offered the warrant

the closing price of CLC stock was $8.50, and on the date he purchased the warrant the closing price was $7.50. During 1973, the highest closing price of CLC stock was $9.38. As respondent's expert, Herbert T. Spiro, testified, an investor considering the purchase of the warrant would have taken into account the current and recent values of CLC common stock in valuing the warrant. Had Howard done so, we feel he would have arrived at a much higher fair market value for the warrant. Because of Howard's failure to do so, we reject his estimate of the warrant's fair market value.

We also reject Howard's contention that, at the time petitioner purchased the warrant, CLC was on the brink of bankruptcy because of its inability to finance the ITT Hamilton insurance purchase. Specifically, Howard argues that

because CLC may have been unable to satisfy the short-term note due ITT Hamilton on March 31, 1973, the future of the company, as well as the value of the warrant, were in doubt. However, we note that petitioner was offered the warrant on February 16, 1973, and the purchase was closed on March 27, 1973. On February 16, 1973, CLC borrowed $6,750,000 from Wells Fargo Bank. Thus, at the time petitioner was offered the warrant as well as when he actually purchased it, CLC had already secured funds to satisfy the short term note due ITT Hamilton on March 31, 1973.

Because we have found that Howard's testimony and appraisal report lack credibility, petitioner has failed to prove that he paid a premium for the warrant. We therefore reject his argument that any such premium is deductible

as an ordinary and necessary business expense.

B. Ordinary and Necessary Business Expense

However, even if petitioner had paid a premium for the warrant, we reject petitioner's argument that any premium which he may have paid for the warrant was an ordinary and necessary business expense under section 162. While he has established that it was beneficial to CLC, and to himself as its chief executive officer, that he have an equity interest in the company, he has not established that it was ordinary and necessary for him to pay a premium for such equity interest.

C. Nondeductible Capital Expenditure

Finally, we conclude that the purchase of the warrant was a nondeductible capital expenditure. When a capital expenditure is incurred, to the

extent that a deduction is allowable, the cost of the expenditure must be recouped under the provisions which permit deduction for amortization, depreciation, depletion, or loss, rather than under section 162(a). See Howard v. Commissioner, 39 T.C. 833 (1963); Clark Thread Co. v. Commissioner, 28 B.T.A. 1128, affd. 100 F.2d 257 (3d Cir. 1938); W.B. Harbeson Co. v. Commissioner, 24 B.T.A. 542 (1931). Generally the purchase of stock is to be considered a capital transaction under section 263 for which no deduction is allowable under section 162(a). Harder Services, Inc. v. Commissioner, 67 T.C. 585 (1976), affd. without opinion 573 F.2d 1290 (2nd Cir. 1977).

Petitioner contends, however, that an exception to the general rule exists where the acquisition of the

corporation's stock is made necessary in order to assure the corporation's continued existence, citing Five Star Manufacturing Co. v. Commissioner, 355 F.2d 724 (5th Cir. 1966), revg. 40 T.C. 379 (1963).

In Five Star Manufacturing Co. v. Commissioner the taxpayer corporation, whose central income producing asset was its license to manufacture and sell an article under a patent held by a third party, found itself in a situation where the patent holder had canceled the license to the taxpayer, and had attached, through court proceedings, two-thirds of its inventory of finished goods. The corporation had no working capital and no credit. The patent holder would consent to renew the license and release his hold on the corporate assets only if one of the two shareholders was

eliminated from any interest in the corporation. The taxpayer therefore purchased the stock of one shareholder and it survived and continued in business. Under these circumstances, the Court of Appeals for the Fifth Circuit concluded that the corporation's expenditures in buying the stock of the shareholder should be considered as ordinary and necessary and deductible under section 162(a), since without such purchase the corporation would have been put out of business.

The Fifth Circuit Court of Appeals, author of Five Star Manufacturing Co. v. Commissioner, has limited that case to its own facts and to those extraordinary situations where the purchasing corporation was faced with extinction absent the purchase in question. In Jim Walter Corp. v. United States, 498 F.2d 631, 639

(5th Cir. 1974), the Fifth Circuit held that Five Star Manufacturing Co. did not establish a general principle that a primary business purpose can convert into a deductible expense and expenditure which is a capital transaction in nature and origin.

This Court has followed the rationale of Jim Walter Corp. v. United States, supra. In Harder Services, Inc. v. Commissioner, supra, the taxpayer corporation repurchased an employee's stock as part of terminating his employment, all of which was done in order to extricate the taxpayer from an unfavorable financial and management situation. The taxpayer, relying on Five Star Manufacturing Co., claimed the right to an ordinary deduction under section 162(a) with respect to the amounts paid to redeem its stock. We refused to extend

the authority of Five Star Manufacturing Co. beyond the extreme situation where corporate survival is at stake, and held that the expenditure was capital in nature.

Petitioner was in the trade or business of being an employee. Primuth v. Commissioner, 54 T.C. 374, 377 (1970). To be entitled to a trade or business deduction, he must show that his payment of a corporate expense was made to protect his own separate trade or business. Petitioner must also show that his survival as an employee of CLC was at stake. Centel Communications Co. v. Commissioner, 92 T.C. 612, 636 (1989). We conclude that petitioner has failed to establish that he purchased the warrant because his survival as an employee of CLC was at stake. While his investment in CLC was instrumental in obtaining financing for

the ITT Hamilton insurance purchase, and was therefore beneficial to both CLC and to petitioner as its employee, petitioner introduced no evidence that such an investment was a precondition to his continued employment by CLC. We therefore hold that Five Star Manufacturing Co. is inapplicable to the instant case, and that the purchase of the warrant was a nondeductible capital expenditure.

II. Recognition of Gain on Transfer of the Warrant for Stock Pursuant to Section 83(a)

Respondent determined that petitioner must recognize gain on the transfer of the warrant for CLC stock in an amount equal to the difference between the fair market value of the stock on the date of transfer and the purchase price of the warrant. Respondent's determination that petitioner must recognize gain of the

transfer of the warrant for CLC stock is based on his argument that section 1.83-7, Income Tax Regs., applies to the purchase of the warrant, resulting in section 83(a) applying to the transfer of the warrant for stock. Petitioner argues that there was no transfer "in connection with the performance of services," and section 83(a) is therefore inapplicable.

Section 83(a) provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not

subject to a substantial risk of forfeiture, whichever occurs earlier, over the amount, if any, paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. A transfer of property occurs for purposes of section 83 when an employee acquires the beneficial ownership interest in such property. Sec. 1.83-3(a)(1), Income Tax Regs.

A "restriction which by its terms will never lapse" (also referred to as a "non-lapse restriction") is a permanent limitation on the transferability of property which: (1) will require the transferee of the property to sell, or

offer to sell, such property at a price determined under a formula; and (2) will continue to apply to and be enforced against the transferee or any subsequent holder. Section 1.83-3(h), Income Tax Regs. A limitation subjecting the property to a permanent right of first refusal in a particular person at a price determined under a formula is a permanent non lapse restriction. Limitations imposed by registration requirements of State or Federal security laws or similar laws imposed with respect to sales or other dispositions of stock or securities are not nonlapse restrictions. Sec. 1.83-3(h), Income Tax Regs. Thus, such limitations are not taken into account in determining the fair market value of the property received.

A. Transfer in Connection with the Performance of Services

Section 83 applies only where property is transferred in connection with the performance of services. For purposes of section 83, a transfer in "recognition of" the performance of services is synonymous with a transfer in "connection with" the performance of services. Sec. 1.83-3(f), Income Tax Regs. Petitioner argues that the purchase of the warrant was made solely for investment purposes, and was therefore unconnected with the performance of services to CLC. Respondent contends that the transfer was made for the purpose of insuring the continued performance of petitioner's services as chief executive officer of CLC, and that therefore the warrant was transferred in connection with the performance of services.

Whether property is transferred in

connection with services is a question of fact. Bagley v. Commissioner, 806 F.2d 169 (8th Cir. 1986), affg. 85 T.C. 663 (1985). The transfer of property is subject to section 83 whether such transfer is in respect of past, present, or future services. Sec. 1.83-3(f), Income Tax Regs. In addition, where property is transferred in connection with services, section 83 is applicable even though the property was purchased at its fair market value at the date of purchase. Alves v. Commissioner, 734 F.2d 478 (9th Cir. 1984), affg. 79 T.C. 864 (1982).

We conclude that in the instant case the warrant was transferred in connection with the performance of services. As the proxy statement explaining the issuance of the warrant makes clear, the warrant was transferred to petitioner in order to assure his continuing services as chief

executive officer of CLC. Therefore, the transfer was made in anticipation of future services by petitioner to CLC.

B. Applicability of Section 83 to a Stock Warrant

With respect to stock options, the regulations provide that if there is granted to an employee in connection with the performance of services an option to which section 421 (relating generally to certain qualified and other options) does not apply, section 83(a) shall apply to such grant if the option has a readily ascertainable fair market value, determined in accordance with the regulations, at the time the option is granted. Sec. 1.83-7(a), Income Tax Regs. For purposes of the regulation, a stock warrant is an option. Pagel, Inc. v. Commissioner, 91 T.C. 200, 205 (1988). Section 421 does not apply to the warrant purchased by

petitioner, and it is therefore governed by section 83(a).

Where a stock option is governed by section 83, the person who performed the services realizes compensation upon such grant at the time and in the amount determined under section 83(a). Sec. 1.83-7(a), Income Tax Regs. For options that do not have a readily ascertainable fair market value at the time of grant, the regulations contemplate that the compensation element of the transaction will be held open until the option is exercised or disposed of. If the option is exercised, section 83(a) applies to the transfer of property pursuant to such exercise, and the employee realizes compensation upon such transfer at the time and in the amount determined under section 83(a). If the option is sold or otherwise disposed of in an arm's-length

transaction, section 83(a) applies to the transfer of money or other property received in the same manner as it would have applied to the transfer of property pursuant to an exercise of the option. Sec. 1.83-7(a), Income Tax Regs. In order to determine the tax consequences of the exchange of the warrant for stock, we must first determine whether the warrant had a readily ascertainable fair market value at the time of grant.

C. Readily Ascertainable Fair Market Value

Options have a value at the time they are granted, but that value is ordinarily not readily ascertainable unless the option is actively traded on an established market. Section 1.83-7(b)(1), Income Tax Regs. In the instant case the warrant was not actively traded on an established market. If an option is not

actively traded on an established market, the option does not have a readily ascertainable fair market value when granted unless the taxpayer can show that all of the following conditions exist:

(1) the option is transferable by the optionee;

(2) the option is exercisable immediately in full by the optionee;

(3) the option or the property subject to the option is not subject to any restriction or condition (other than a lien or other condition to secure the payment of the purchase price) which has a significant effect upon the fair market value of the option; and

(4) the fair market value of the "option privilege" is readily ascertainable in accordance with section 1.83-7(b)(3), Income Tax Regs. Sec. 1.83-7(b)(2), Income Tax Regs.

We find that petitioner has failed to establish the fourth condition, that the fair market value of the "option privilege" is readily ascertainable. The "option privilege" in the case of an option to buy is the opportunity to benefit during the option's exercise period from any increase in the value of property subject to the option during such period, without risking any capital. Sec. 1.83-7(b)(2), Income Tax Regs.

In determining whether the value of the option privilege is readily ascertainable, and in determining the amount of such value when such value is readily ascertainable, it is necessary to consider:

(1) whether the value of the property subject to the option can be ascertained;

(2) the probability of any ascertain-

able value of such property increasing or decreasing; and

(3) the length of the period during which the option can be exercised. Section 1.83-7(b)(3), Income Tax Regs.

In Morrison v. Commissioner, 59 T.C. 248, 260 (1972), this Court held that the option privilege of the warrants before us did had a readily ascertainable value. In so holding, we emphasized the fact that the warrants provided for the receipt of valuable stock by payment of a nominal sum, leading to the conclusion that the warrants, although they had three year terms, would be exercised immediately.

In Frank v. Commissioner, 54 T.C. 75, 89-94 (1970) affd. 447 F.2d 552 (7th Cir. 1971), this Court held that the option privilege of the warrant before us did not have a readily ascertainable value.

In so holding, we noted the uncertainty in measuring the future prospects for success of the company to which the warrant related.

Morrison v. Commissioner is distinguishable from the instant case because the sum which was payable by petitioner for stock of CLC was not nominal. The instant case, we conclude, is comparable to Frank v. Commissioner, in that there existed a great deal of uncertainty in measuring the future prospects for success by CLC. We therefore find that the value of the option privilege was not ascertainable, and as a result the warrant did not have a readily ascertainable fair market value at the time it was granted.

Because the warrant did not have a readily ascertainable fair market value at the time it was granted, the compensa-

tion element of the transaction is held open until the warrant is disposed of. In the instant case, the warrant was disposed of when it was exchanged for 90,000 shares of CLC stock. We must therefore apply section 83(a) to the transfer of the CLC stock for the warrant.

D. Amount of Income Recognized Under Section 83(a)

1. Arm's-Length Transaction

As a preliminary matter we reject petitioner's contention that the exchange of the warrant for stock was not an arm's length transaction, and that section 1.83-7(a), Income Tax Regs., is therefore inapplicable. Because the exchange was approved by the shareholders of CLC, we find that it was conducted at arm's length.

2. "Amount Paid" for CLC Stock

The term "amount paid" refers to the value of any money or property paid for the transfer of property to which section 83 applies. When section 83 applies to the transfer of property pursuant to the exercise of an option, the term "amount paid" refers to any amount paid for the grant of the option plus any amount paid as the exercise of the option. Sec. 1.83-3(g), Income Tax Regs. In the instant case the warrant was not exercised, and therefore the "amount paid" is the $103,500 which petitioner paid for the warrant.

3. Fair Market Value of CLC Stock

In order to determine the amount of income which petitioner must recognize under section 83(a), we must determine the fair market value of the 90,000 shares of CLC stock on the date of the

exchange. Both parties introduced the testimony and reports of expert witnesses with respect to such fair market value.

As a preliminary matter, we note that limitations imposed by registration requirements of State or Federal security laws or similar laws imposed with respect to sales or other dispositions of stock are not non-lapse restrictions, and therefore such limitations are not taken into account in determining the fair market value of the property received for the warrant. However, in his notice of deficiency respondent reduced the fair market value of the CLC stock 27 percent on account of its lack of registration, which in turn reduced the amount of gain which, according to respondent, petitioner must recognize. Respondent did not argue for a larger fair market value, and therefore a larger deficiency, at trial

or in brief.

a. Petitioner's Expert

Petitioner's expert witness, Robert F. Howard, began his analysis of the value of the 90,000 shares of CLC stock received in the exchange with the market value of the shares as of May 21, 1976, or $393,750 ($4.375 per share). Howard then applied three separate discounts in determining that the fair market value of the restricted stock as of May 21, 1976, was $22,500 ($0.25 per share).

Howard first determined that an appropriate discount for lack of marketability of the shares is 35 percent. Such a discount is necessary, Howard concluded, because the shares are not registered. In computing the appropriate discount for lack of marketability, Howard relied in large part on previous opinions of this Court in which we had found a discount

for lack of registration to be appropriate. Howard determined the average discount in these cases and used such average in determining the appropriate discount in the instant case. The cases on which Howard relies date as far back as 1942.

Howard next determined a blockage discount. Because the share block is substantial relative to the number of shares traded, Howard reasons, an attempt to sell the shares would tend to flood the market and to depress the market price of the shares. Based on his experience in dealing with investment bankers and market makers, Howard arrived at a blockage discount of 10 percent.

Finally, Howard determined that a discount for alienability is appropriate. This discount is not attributable to a restriction on the share block, Howard

reasons, but is due to the circumstances under which petitioner received the shares. Howard states that the board of directors of CLC did not authorize the issuance of the shares under its own authority, but instead had the shareholders authorize the issuance. Under these circumstances, Howard states, "we are informed that if Mr. Mitchell attempted to sell the Share Block on May 21, 1976, or shortly thereafter, any shareholder could bring suit to rescind the sale under California common law or Federal securities laws on grounds that the proxy statement was false and misleading." Howard also states that "we are further informed that such a suit would have a good chance of success." Based on these assumptions, Howard concludes that the 90,000 shares had only a speculative value of $0.25 per share.

We do not accept petitioner's appraisal. First, we reject his method of determining the discount for lack of registration. Any such discount must be determined by examining the specific facts of the instant case, not by reference to past decisions of this Court involving totally different facts. Next, we reject his method of determining the 10 percent discount for blockage. Howard did not provide any specific facts on which to base such a discount. Finally, we reject Howard's conclusion that a discount for alienability is appropriate. Petitioner introduced no evidence which would indicate that such a discount would be appropriate in the instant case.

b. Respondent's Expert

Respondent's expert witness, Howard T. Spiro, also began his analysis with the

market value of the 90,000 shares as of May 21, 1976. Spiro then tabulated information from four entities publishing data on the valuation of restricted securities for 1976 (Claremont Capital Corporation, New American Fund, Inc., Source Capital, Inc., Value Line Development Capital Corp.), and arrived at an average discount for restricted securities in 1976 of 27 percent. Spiro then applied the 27 percent discount to the market value of the shares and arrived at a fair market value for the restricted shares of $287,437.50. The 27 percent discount took into account any necessary discount for blockage. We conclude that the fair market value of the restricted stock issued to petitioner was $287,437.50 as of May 21, 1976, as determined by respondent's expert witness.

Having determined the price paid for

the warrant and the fair market value of the 90,000 shares of CLC stock, we sustain respondent's determination that the difference between them is taxable to petitioner as ordinary income in 1976.

IV. Exclusion of Damages Received On Account of Personal Injury

Under section 61(a) "gross income" means all income from whatever source derived, unless otherwise provided. Section 104(a)(2) excludes from gross income damages received on account of personal injuries or sickness. "Damages received" means an amount received through prosecution of a legal action based on tort-type rights, or through a settlement agreement entered into in lieu of such prosecution. Sec. 1.104-1(c), Income Tax Regs.

In the context of a settlement agreement, the availability of the

section 104(a)(2) exclusion from gross income depends on the nature of the claim settled, not on the validity of the claim. Seay v. Commissioner, 58 T.C. 32, 37 (1972). This determination is a factual one, and petitioner bears the burden of providing that respondent's determination is erroneous. Rule 142(a). In the absence of an express personal injury settlement agreement, the most important factor in applying section 104(a)(2) is the intent of the payor in making the payment. Metzger v. Commissioner, 88 T.C. 834, 847-848 (1987), affd. without published opinion 845 F.2d 1013 (3d Cir. 1988).

Petitioner relies on Seay v. Commissioner, supra, in arguing that the $100,511 he received from CLC during 1980 are excludable from gross income under section 104(a)(2) as damages for personal

injuries. In Seay v. Commissioner the taxpayer made claims against his former employer for breach of contract and personal injuries arising out of the termination of his employment He received $105,000 in settlement of his claims. At the time of the settlement, both the attorney for the taxpayer and the employer's attorney agreed in writing that $45,000 had been allocated to the personal injury claim. We held that the taxpayer had shown that $45,000 of the payment was made on account of personal injuries and was excludable from gross income under section 104(a)(2).

In arguing that the instant case is indistinguishable from Seay v. Commissioner, petitioner relies on the "Principles of Settlement" which he drafted and which state that "of the three payments of $50,000 *** $100,000

will be deemed to be in settlement of employee's lawsuit against CLC, CLIC and various officers and directors for compensatory damages for slander and libel ***." For several reasons we find that the "Principles of Settlement" are insufficient to establish that the payments are excludable under section 104(a)(2).

First, we note that the complaint for libel and slander was never served on the defendants. Second, we note that the "Principles of Settlement" were never signed by CLC's attorney or approved by its board of directors. In addition, two members of CLC's board of directors testified that they did not consider the libel action in approving the settlement agreement with petitioner, and stated that they considered the action a mere nuisance suit. Next, we note that the

Amended Employment Agreement which was executed pursuant to the settlement agreement refers to the payments at issue as "compensation." We also note that CLC issued petitioner a Form W-2 reflecting the full $100,511 in payments as "wages, tips, or other compensation." Finally, in the pleadings for the action which petitioner filed in 1981 for an alleged breach of the Amended Employment Agreement, petitioner declared that in return for signing the settlement agreement with CLC, petitioner was to receive "in full settlement of the six-year period remaining on his employment contract *** the sum of $150,000 payable in installments over a nine-months period."

We find that the payments at issue were made in settlement of petitioner's employment agreement, rather than in settlement of the libel and slander

action. Therefore, such payments are not excludable under section 104(a)(2), and respondent's determination is sustained.

V. Net Operating Loss Carry Back

Congress substantially revised the Subchapter S Internal Revenue Code sections in the Subchapter S Revision Act of 1982. As part of the revision Congress enacted section 1371(b), providing that "[n]o carryforward, and no carryback, arising for a taxable year for which a corporation is a C corporation may be carried to a taxable year for which such corporation is an S corporation," and "No carryforward, and no carryback shall arise at the corporate level for a taxable year for which a corporation is an S corporation." However, section 1371(b) applies to taxable years beginning after December 31, 1982. Thus, section 1371(b) is inapplicable to the years at issue.

Petitioners argue that prior to the enactment of section 1371(b) there was no prohibition against the carry back of a net operating loss to a year for which a corporation is an S corporation. Respondent argues that such a prohibition was implicit in section 1374 and the regulations thereunder. Deductions from income are allowable as a matter of legislative grace, and petitioners bear the burden of proving they are entitled to them. Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934); Welch v. Helvering, 290 U.S. 111 (1933).

With regard to the inability of a corporation in a subchapter S year to take advantage of a loss generated in a subchapter C year, the regulations provide, in relevant part:

Under section 1373(d), an electing

small business corporation is not allowed a deduction for a net operating loss. Under section 172(h), a net operating loss sustained in taxable years in which a corporation is an electing small business corporation is disregarded in computing the net operating loss deduction of the corporation for taxable years in which it is not an electing small business corporation. In applying section 172(b)(1) and (2) to a net operating loss sustained in a taxable year in which the corporation was not an electing small business corporation, a taxable year in which the corporation was an electing small business corporation is counted as a taxable year to which such net operating loss is carried back or over. However, the taxable income for such year as deter-

mined under section 172(b)(2) is treated as if it were zero for purposes of computing the balance of the loss available to the corporation as a carryback or carryover to other taxable years in which the corporation is not an electing small business corporation. Section 1.1374-1(a), Income Tax Regs.

Under these regulations, a subchapter S year will be counted as a year for purposes of the carry back and carry forward periods. However, income in the subchapter S year will be regarded as zero, resulting in no part of the net operating loss carry back or carry forward being absorbed. Because no part of the net operating loss carry back is absorbed, no part of the carry back passes through to the shareholders. We agree with respondent that section

1371(b)'s prohibition of a carryback from a C year to an S year was implicit in the regulations prior to the enactment of that statute. We therefore sustain respondent's determination that no part of Leslie Investment Company's 1981 loss passed through to petitioners in 1980, a year in which Leslie Investment Company was an electing small business corporation.

In light of the foregoing,

Decision will be entered under Rule 155.

APPENDIX C

APPENDIX C

26 U.S.C. Sec. 83

§83. Property transferred in connection with performance of services.

(a) **General rule.**--If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of--

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property,

shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

(b) **Election to include in gross income in year of transfer.--**

(1) **In general.**--Any person who performs services in connection with which property is transferred to any person may elect to include in his gross income, for the taxable year in

which such property is transferred, the excess of--

(A) the fair market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over

(B) the amount (if any) paid for such property.

If such election is made, subsection (a) shall not apply with respect to the transfer of such property, and if such property is subsequently forfeited, no transfer of such property, and if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture.

(2) **Election.**--An election under paragraph (1) with respect to any transfer of property shall be made in

such manner as the Secretary prescribes and shall be made not later than 30 days after the date of such transfer. Such election may not be revoked except with the consent of the Secretary.

(c) **Special rules**.--For purposes of this section--

(1) **Substantial risk of forfeiture**.--The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.

(2) **Transferability of property**.--The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture.

(3) **Sales which may give rise to suit under section 16(b) of the Securities Exchange Act of 1934.**--So long as the sale of property at a profit could subject a person to suit under section 16(b) of the Securities Exchange Act of 1934, such person's rights in such property are--

(A) subject to a substantial risk of forfeiture, and

(B) not transferable.

(d) **Certain restrictions which will never lapse.**--

(1) **Valuation.**--In the case of property subject to a restriction which by its terms will never lapse, and which allows the transferee to sell such property only at a price determined under a formula, the price so determined shall be deemed to be the fair

market value of the property unless established to the contrary by the Secretary, and the burden of proof shall be on the Secretary with respect to such value.

(2) **Cancellation**.--If, in the case of property subject to a restriction which by its terms will never lapse, the restriction is canceled, then, unless the tax payer establishes--

(A) that such cancellation was not compensatory, and

(B) that the person, if any, who would be allowed a deduction if the cancellation were treated as compensatory, will treat the transaction as not compensatory, as evidenced in such manner as the Secretary shall prescribe by regulations,

the excess of the fair market value of the

property (computed without regard to the restrictions) at the time of cancellation over the sum of--

(C) the fair market value of such property (computed by taking the restriction into account) immediately before the cancellation, and

(D) the amount, if any, paid for the cancellation,

shall be treated as compensation for the taxable year in which such cancellation occurs.

(e) **Applicability of section.**--This section shall not apply to--

(1) a transaction to which section 421 applies,

(2) a transfer to or from a trust described in section 401(a) or a transfer under an annuity plan which meets the requirements of section 404(a)(2),

(3) the transfer of an option without a readily ascertainable fair market value,

(4) the transfer of property pursuant to the exercise of an option with a readily ascertainable fair market value at the date of grant, or

(5) group-term life insurance to which section 79 applies.

(f) **Holding period.**--In determining the period for which the taxpayer has held property to which subsection (a) applies, there shall be included only the period beginning at the first time his rights in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier.

(g) **Certain exchanges.**--If property to which subsection (a) applies is exchanged for property subject to restrictions and

conditions substantially similar to those to which the property given in such exchange was subject, and if section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) applied to such exchange, or if such exchange was pursuant to the exercise of a conversion privilege--

(1) such exchange shall be disregarded for purposes of section (a), and

(2) the property received shall be treated as property to which subsection (a) applies.

(h) **Deduction by employer.**--In the case of a transfer of property to which this section applies or a cancellation of a restriction described in subsection (d), there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection

with which such property was transferred, an amount equal to the amount included under subsection (a), (b), or (d)(2) in the gross income of the person who performed such services. Such deduction shall be allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed such services.

[(i) **Repealed.** Pub.L 101-508, Title XI, § 11801(a)(5), Nov. 5, 1990, 104 Stat. 1388-520]

(added Pub.L. 91-172, Title III, § 321(a), Dec. 30, 1969, 83 Stat. 588, and amended Pub.L. 94-455, Title XIX, §§ 1901(a)(15), 1906(b)(13)(A), Oct. 4 1976, 90 Stat. 1765, 1834; Publ.L. 97-34, Title II, § 252(a), Aug. 13, 1981, 95 Stat. 260; Pub.L. 97-448, Title I, 102(k)(1), Jan 12, 1983, 96 Stat. 2374; Pub.L. 98-369, Div.

A, Title II, § 223(c), July 18, 1984, 98 Stat. 775; Pub.L. 99-514, Title XVIII, § 1827(e), Oct. 22, 1986, 100 Stat. 2851; Pub.L. 101-508, Title XI, § 11801(a)(5), Nov. 5, 1990, 104 Stat. 1388-520.)

APPENDIX D

APPENDIX D

U.S. Income Tax Regulations Section 1.83-7 (26 CFR 1.83-7)

§ 1.83-7 Taxation of nonqualified stock options.

(a) **In general.** If there is granted to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services, an option to which section 421 (relating generally to certain qualified and other options) does not apply, section 83(a) shall apply to such grant if the option has a readily ascertainable fair market value (determined in accordance with paragraph (b) of this section) at the time the option is granted. The person who performed such services realizes compensation upon such grant at the time and in the amount determined under section 83(a). If section 83(a) does not

apply to the grant of such an option because the option does not have a readily ascertainable fair market value at the time of grant, sections 83(a) and 83(b) shall apply at the time the option is exercised or otherwise disposed of, even though the fair market value of such option may have become readily ascertainable before such time. If the option is exercised, sections 83(a) and 83(b) apply to the transfer of property pursuant to such exercise, and the employee or independent contractor realizes compensation upon such transfer at the time and in the amount determined under section 83(a) and 83(b). If the option is sold or otherwise disposed of in an arm's length transaction, sections 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as sections 83(a) and 83(b) would have

applied to the transfer of property pursuant to an exercise of the option.

(b) **Readily Ascertainable Defined--**

(1) **Actively traded on an established market.** Options have a value at the time they are granted, but that value is ordinarily not readily ascertainable unless the option is actively traded on an established market. If an option is actively traded on an established market, the fair market value of such option is readily ascertainable for purposes of this section by applying the rules of valuation set forth in § 20.2031-2.

(2) **Not actively traded on an established market.** When an option is not actively traded on an established market, it does not have a readily ascertainable fair market value unless its fair market value can otherwise be measured with reasonable accuracy. For purposes of

this section, if an option is not actively traded on an established market, the option does not have a readily ascertainable fair market value when granted unless the taxpayer can show that all of the following conditions exist:

(i) The option is transferable by the optionee;

(ii) The option is exercisable immediately in full by the optionee;

(iii) The option or the property subject to the option is not subject to any restriction or condition (other than a lien or other condition to secure the payment of the purchase price) which has a significant effect upon the fair market value of the option; and

(iv) The fair market value of the option privilege is readily ascertainable in accordance with paragraph (b)(3) of this section.

(3) **Option privilege.** The option privilege in the case of an option to buy is the opportunity to benefit during the option's exercise period from any increase in the value of property subject to the option during such period, without risking any capital. Similarly, the option privilege in the case of an option to sell is the opportunity to benefit during the exercise period from a decrease in the value of property subject to the option. For example, if at some time during the exercise period of an option to buy, the fair market value of the property subject to the option is greater than the option's exercise price, a profit may be realized by exercising the option and immediately selling the property so required for its higher fair market value. Irrespective of whether

any such gain may be realized immediately at the time an option is granted, the fair market value of an option to buy includes the value of the right to benefit from any future increase in the value of the property subject to the option (relative to the option exercise price), without risking any capital. Therefore, the fair market value of an option is not merely the difference that may exist at a particular time between the option's exercise price and the value of the property subject to the option, but also includes the value of the option privilege for the remainder of the exercise period. Accordingly, for purposes of this section, in determining whether the fair market value of an option is readily ascertainable, it is necessary to consider whether the value of the entire option privilege can be measured with reasonable

accuracy. In determining whether the value of the option privilege is readily ascertainable, and in determining the amount of such value when such value is readily ascertainable, it is necessary to consider --

(i) Whether the value of the property subject to the option can be ascertained;

(ii) The probability of any ascertainable value of such property increasing or decreasing; and

(iii) The length of the period during which the option can be exercised.

(c) **Reporting requirements.** [Reserved]

APPENDIX E

APPENDIX E

EXCERPT FROM

TAX REFORM ACT OF 1969 *

House Report

J. RESTRICTED PROPERTY

(Sec. 321 of the bill and secs. 85, 402(b), and 403(c) of the code)

Present law.--Present law does not contain any specific rules governing the tax treatment of deferred compensation arrangements known as restricted stock plans.

A restricted stock plan, generally, is an arrangement under which an employer transfers stock to one or more of his employees (often without the payment of any consideration), where the stock is subject to certain restrictions which

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* Taken from 1969 U.S. Code Cong. & Ad. News 1733 - 1736

affect its value. A restricted stock plan may cover only one employee or it may cover a number of employees. The stock transferred under a plan may be stock in the employer corporation, stock of another company--often an unrelated growth company--or even shares of a mutual fund.

The restrictions which are imposed on the stock are of various types. One type of restriction often imposed requires the employee to return the stock to the employer if he does not complete a specified additional period of employment and prohibits the employee from selling the stock in the interim. Another common type of restriction provides that the employee may not sell the stock for a specified period of time, such as a 5-year period, or until he retires.

The existing Treasury regulations generally provide that no tax is imposed when the employee receives the restricted stock. Tax is deferred until the time the restrictions lapse; at that time, only the value of the stock when it was transferred to the employee (determined without regard to restrictions) is treated as compensation, provided the stock has increased in value. If the stock has decreased in value in the interim, then the lower value at the time the restrictions lapse is considered the amount of compensation. Thus, under existing regulations there is a deferral of tax with respect to this type of compensation, and any increase in the value in the stock between the time it is granted and the time when the restrictions lapse is not treated as compensation.

General reasons for change.--The present treatment of restricted stock plans is significantly more generous than the treatment specifically provided in the law for similar types of deferred compensation arrangements. Under present law an employee is taxed in full when his employer makes a contribution for his benefit to an employees' pension or profit-sharing trust which does not meet the nondiscrimination and other requirements set forth in the tax law, if his interest in the contribution is nonforfeitable. (A similar rule applies where an employer purchases an annuity for an employee). If an employer transfers stock to such an employees' trust for an employee and the trust provides that the employee will receive the stock at the end of 5 years if he is alive at that

time, the employee would be treated as receiving, and would be taxed on, compensation in the amount of the value of the stock at the time of the transfer.

However, if the employer, instead of contributing the stock to the trust, gives the stock directly to the employee subject to the restriction that it cannot be sold for 5 years, then the employee's tax is deferred until the end of the 5-year period. The disparity of treatment between the two situations becomes even more apparent when it is considered that in the situation where the employee has substantially less than full control of the stock (the nonexempt trust situation) he is taxed currently on the full value of the stock, while in the case where the employee actually possesses the stock, can vote the stock, and receives the dividends on the stock (the restricted

stock plan), his tax is deferred).

It has been suggested by some that restricted stock plans are not, in fact, deferred compensation arrangements, but rather are a means of allowing key employees to become shareholders in the business. Your committee believes, however, that this line of reasoning overlooks the fact that in 1964 Congress specifically dealt with the matter of the appropriate means by which key employees could be provided with a stake in the business when it revised the treatment of qualified employee stock options.

A series of specific requirements were provided by Congress which must be satisfied in order to obtain favorable tax treatment in the case of stock options. A number of these requirements were designed to decrease the compensatory nature of stock options and to place more

emphasis on stock options as a means of giving employees a stake in the operation of their business. Your committee does not believe it was intended that substantially similar tax benefits should be available under a slightly different type of arrangement, such as a restricted stock plan, where none of the conditions which it specified for qualified stock options must be satisfied. For example, a stock option qualifies only if it is issued at 100 percent of the market price of the stock at the time of issuance. Thus, to acquire stock pursuant to the option, the employee would have to pay the full market price of the stock as of the option issuance date. Restricted stock, on the other hand, may be given to an employee for no consideration at all. Thus, the employee has to pay nothing to obtain the stock.

To the extent that a restricted stock plan can be considered a means of giving employees a stake in the business, your committee believes the present tax treatment of these plans is inconsistent with the specific rules provided by Congress in the case of qualified stock options, which were considered by Congress as the appropriate means by which an employee could be given a shareholder's interest in the business.

Explanation of provision.--For the above reasons, your committee's bill provides that a person who receives a beneficial interest in property by reason of the performance of services is to be taxed with respect to the property at the time of receipt, either if his interest in the property is transferable, or it is not subject to a substantial risk of

forfeiture. In this case, the person is to be required to include in income the amount by which the fair market value of the property exceeds the amount (if any) he paid for the property. For this purpose, the fair market value of the property is to be determined without regard to any restriction, except a restriction which by its terms will never lapse. Restrictions which by their terms never lapse, for example, a requirement that an employee sell the stock back to the employer at book value or a formula price if he terminates his employment, are not, in your committee's opinion, tax-motivated and should be distinguished from restrictions designed to achieve deferral for tax saving purposes.

If, at the time the property is transferred to the person, his interest in the property is both nontransferrable

and subject to a substantial risk of forfeiture, he is not to be required to include any amount in income with respect to the property until such time as his interest in the property either becomes transferable (free of forfeiture in the hands of the transferee) or no longer is subject to a substantial risk of forfeiture. A substantial risk of forfeiture will be considered to exist where the person's rights to the full enjoyment of the property are conditioned upon his future performance of substantial services. In other cases the question of whether there is a substantial risk of forfeiture depends upon the facts and circumstances.

In the situation where a person is allowed to sell property only at a price determined under a formula, and this restriction by its terms will never

lapse, the restriction is taken into account in valuing the property. In such a case, the restriction is an inherent limitation on the recipient's property rights, and the employee's income should be determined accordingly. The bill provides that the formula price is to be deemed to be the fair market value of the property, unless established to the contrary by the Secretary or his delegate.

If a restriction on property, which by its terms would never lapse, is canceled, the owner of the property, in effect, is to include in income as compensation, for the taxable year in which the cancellation occurs, the amount on which he originally was not taxed because of the decrease in value attributed to the restriction. The bill provides that the amount included in income is to be the

excess of the fair market value of the property (computed without regard to the restrictions) at the time of cancellation over the sum of: (1) the fair market value of such property (computed by taking the restriction into account) immediately prior to the cancellation, and (2) the amount, if any, paid for the cancellation. This rule is not to apply, however, if the owner of the property can establish in the manner prescribed by the Secretary or his delegate that the cancellation is not compensatory and that the person who would be entitled to a deduction if it were compensatory, will not treat the transaction as compensatory.

The rules provided by the bill with respect to a restricted property do not apply to (1) a transaction to which section 421 of the code (relating to

stock options applies, (2) a transfer to a trust described in section 401(a) of the code relating to qualified employees pension, and profit sharing plans, (3) the transfer of an option without a readily ascertainable fair market value, or (4) the transfer of property pursuant to the exercise of an option with a readily ascertainable fair market value at the date of grant.

The holding period for property subject to the restricted property rules prescribed by the bill is to begin at the first time the taxpayer's rights in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier (i.e., the time he is deemed to receive the compensation).

Generally, these rules are to apply to property transferred after June 30, 1969.

The bill also provides transition rules, however, under which the following situations are not to be subject to the new rules: (1) where property is transferred pursuant to a binding written contract entered into before April 22, 1969, (2) where property is transferred upon the exercise of an option granted before April 22, 1969, or (3) where property is transferred before February 1, 1970, pursuant to a written plan adopted and approved before July 1, 1969.

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APPENDIX F

APPENDIX F

Excerpt from Tax Reform Act of 1969

Senate Report *

H. RESTRICTED PROPERTY

(Sec. 321 of the bill and secs. 83,402(b), and 403(c) of the code)

Present law.--Present law does not contain any specific rules governing the tax treatment of deferred compensation arrangements known as restricted stock plans.

A restricted stock plan, generally, is an arrangement under which an employer transfers stock to one or more of his employees (often without the payment of any consideration), where the stock is subject to certain restrictions which affect its value. A restricted stock

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* Taken from 1969 U.S. Code Cong. & Ad. News 2150 - 2155.

plan may cover only one employee or it may cover a number of employees. The stock transferred under a plan may be stock in the employer corporation, stock of another company--often an unrelated growth company--or even shares of a mutual fund.

The restrictions which are imposed on the stock are of various types. One type of restriction often imposed requires the employee to return the stock to the employer if he does not complete a specified additional period of employment and prohibits the employee from selling the stock in the interim. Another common type of restriction provides that the employee may not sell the stock for a specified period of time, such as a 5-year period, or until he retires.

The existing Treasury regulations

generally provide that no tax is imposed when the employee receives the restricted stock. Tax is deferred until the time the restrictions lapse; at that time, only the value of the stock when it was transferred to the employee (determined without regard to restrictions) is treated as compensation, provided the stock has increased in value. If the stock has decreased in value in the interim, then the lower value at the time the restrictions lapse is considered the amount of compensation. Thus, under existing regulations there is a deferral of tax with respect to this type of compensation, and any increase in the value of the stock between the time it is granted and the time when the restrictions lapse is not treated as compensation.

The existing Treasury Regulations also provide that the employer is entitled to

deduct compensation at the time and in the same amount as the employee is considered to have realized income. In the case of nonexempt trusts, however (where the income to the recipient is deferred if his rights to the contribution are forfeitable), employers under the regulations are not allowed deductions for property contributed to these trusts.

General reasons for change.--The present tax treatment of restricted stock plans is significantly more generous than the treatment specifically provided in the law for other types of similarly funded deferred compensation arrangements. An example of this disparity can be seen by comparing the situation where stock is placed in a nonexempt employees' trust rather than given directly to the employee subject to restrictions. If an

employer transfers stock to a trust for an employee and the trust provides that the employee will receive the stock at the end of 5 years if he is alive at that time, the employee is treated as receiving and is taxed on the value of the stock at the time of the transfer. However, if the employer, instead of contributing the stock to the trust, gives the stock directly to the employee subject to the restriction that it cannot be sold for 5 years, then the employee's tax is deferred until the end of the 5-year period. In the latter situation, the employee actually possesses the stock, can vote it, and receives the dividends, yet his tax is deferred. In the case of the trust, he may have none of these benefits, yet he is taxed at the time the stock is transferred to the trust.

It has been suggested by some that restricted stock plans are not in fact, deferred compensation arrangements, but rather are a means of allowing key employees to become shareholders in the business. This line of reasoning, however, overlooks the fact that in 1964 Congress specifically dealt with the matter of the appropriate means by which key employees could be provided with a stake in the business when it revised the treatment of qualified employee stock options.

A series of specific requirements were provided by Congress at that time which must be satisfied in order to obtain favorable tax treatment in the case of stock options. A number of these requirements were designed to decrease the compensatory nature of stock options and

to place more emphasis on stock options as a means of giving employees a stake in the operation of their business. Agreeing with the House bill, the committee does not believe it was intended that substantially similar tax benefits should be available under a slightly different type of arrangement, such as a restricted stock plan, where none of the conditions which it specified for qualified stock options must be satisfied.

To the extent that a restricted stock plan can be considered a means of giving employees a stake in the business, the committee believes the present tax treatment of these plans is inconsistent with the specific rules provided by Congress in the case of qualified stock options, which were considered by Congress as the appropriate means by which an employee could be given a shareholder's interest

in the business.

Explanation of provisions.--Both the House bill and the committee amendments provide that a person who receives a beneficial interest in property, such as stock, by reason of his performance of services is to be taxed on the value of the property at the time of receipt unless his interest in the property is subject to a substantial risk of forfeiture. In this latter case, he is to be taxed on the value of the property at the time the risk of forfeiture is removed.

If there is no substantial risk of forfeiture, the recipient of the beneficial interest is required to include income at the time of the receipt of the property the excess of the fair market value of the property over the amount paid for it. For this purpose, the fair market value of the property is to be

determined without regard to any restriction, except a restriction which by its terms will never lapse. Agreeing with the House bill, the committee feels that restrictions which by their terms never lapse--for example, a requirement that an employee sell his stock back to the employer at book value or some other reasonable price if he terminates his employment--are not tax motivated and should be distinguished from restrictions designed to achieve deferral for tax saving purposes.

If, at the time the property is transferred to the person, his interest in the property is subject to a substantial risk of forfeiture, he is not to be required to include any amount in income with respect to the property until such time as his interest in the property either becomes transferable or no longer

is subject to a substantial risk of forfeiture. A substantial risk of forfeiture will be considered to exist where the person's rights to the full enjoyment of the property are conditioned upon his future performance of substantial services. In other cases, the question of whether there is a substantial risk of forfeiture depends upon the facts and circumstances. An interest in property will be considered to be transferable only, if the rights of a transferee are not subject to any substantial risk of forfeiture.

In the situation where a person is allowed to sell property only at a price determined under a formula, and this restriction by its terms will never lapse, the restriction is taken into account in valuing the property. In such a case, the restriction is an inherent

limitation on the recipient's property rights, and his income should be determined accordingly. The bill provides that the formula price is to be deemed to be the fair market value of the property, unless established to the contrary by the Secretary or his delegate.

If a restriction on property which by its terms will never lapse is canceled, the owner of the property, in effect, is to include in income as compensation, for the taxable year in which the cancellation occurs, the net increase in value he realizes as a result of the cancellation. The bill provides that the amount included in income is to be the excess of the fair market value of the property (computed without regard to the restriction) at the time of cancellation over the sum of: (1) the fair market value of such property (computed by

taking the restriction into account) immediately before the cancellation, and (2) the amount, if any, paid for the cancellation. The rule is not to apply, however, if the owner of the property can establish that the cancellation is not compensatory and that the person who would be entitled to a deduction if it were compensatory will not treat the transaction as compensatory.

The rules provided by the bill with respect to restricted property are not to apply to: (1) a transaction which involves a stock option (to which sec. 421 applies); (2) a transfer to or from a qualified trust (described in section 401(a)) or to a transfer under an annuity plan meeting the requirements of section 404(a) (2); (3) the transfer of an option without a readily ascertainable fair market value; or (4) the transfer of

property pursuant to the exercise of an option with a readily ascertainable fair market value at date of grant. The exception for qualified annuity plans was not in the House bill.

The holding period for property subject to the restricted property rules prescribed by the bill is to begin at the first time the taxpayer's rights in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier (i.e., the time he is deemed to receive compensation).

The committee, in accord with the House bill, modified the tax treatment of nonexempt trusts and nonqualified annuities to conform with the treatment of restricted property. Thus, if an employer contributes cash to a nonqualified trust or a nonqualified

annuity plan and the employee's rights are forfeitable when the contribution is made but subsequently become nonforfeitable, the employee is to be taxable on the contribution at the first time his rights are not subject to a substantial risk of forfeiture instead of the later time when the contribution is distributed to him under the annuity contract (as provided by present law except in the case of annuities purchased by exempt organizations).

The committee adopted provisions to make it clear that in the case of nonexempt trusts and nonqualified annuities, the amount subject to tax when the employee's interest becomes nonforfeitable is the value at that time of his interest in the trust (or the then value of the annuity contract). The value of the amounts subsequently contributed by the

employer to the trust (or premiums subsequently paid) are to be included in the income of the employee when contributed or paid to the trust (or insurer), if the employee's interest in such amounts is nonforfeitable.

Although the committee adopted the major provisions of the House bill relating to restricted stock, it made several minor modifications.

The House bill requires the recognition of income by an employee upon receipt even though his interest in the property is forfeitable if it is transferable. The committee believes that the employee should not be treated as realizing income merely because he can give his forfeitable interest to another person, if the other person is also subject to the forfeitability condition. The committee change provides than an interest

in property is to be considered to be transferable only if a transferee would not be subject to the forfeitability conditions--for example, where the employee has a forfeitable interest in stock, but the fact of forfeitability is not indicated on the stock certificate, and a transferee would have no notice of it.

Under another modification made by the committee, where the employee gives forfeitable property to another person, he (and not the donee) would be taxable at the time the donee's rights become nonforfeitable. However, if an employee who has a forfeitable interest in property sells the property in an arm's length transaction, the employee will be treated as realizing income at that time.

To add flexibility, the committee adopted a provision allowing recipients

of restricted property the option of treating it as compensation in the year it is received, even though it is nontransferrable and subject to a substantial risk of forfeiture. If this election is made, the restricted property rules are not to apply, and later appreciation in the value of the property is not to be treated as compensation. However, if the property is later forfeited, no deduction is to be allowed with respect to the forfeiture. The employee must make this election not later than 30 days after the date of transfer (or the date of enactment of the bill, if later). The election may not be revoked except with the consent of the Secretary of the Treasury or his delegate.

Another provision adopted by the committee provides that the restricted

property rules will not apply to premiums paid by an employer under nontrusteed employee annuity plans which meet the requirements for tax exemption (of section 401(a)). Also, the restricted property rules will not apply to any amount, excluded from gross income (under section 403(b)) in the case of annuities purchased for an employee by an educational or charitable (section 501(c) (3)) organization.

The committee amendments provide that if restricted stock (or other property) is exchanged in a tax-free exchange for other stock (or property) subject to substantially the same restrictions, the exchange will not cause the holder of the stock to become taxable, and the stock received in the exchange will be treated as restricted property. The same principal applies where stock not subject to

the restricted property provision because of the effective date is exchanged in a tax-free exchange. The stock received in the exchange is not to be treated as subject to the new restricted property rules if it is subject to substantially the same restrictions as the stock given up.

The committee provided rules for the employer's deduction for restricted property given to the employees as compensation. The allowable deduction is the amount which the employee is required to recognize as income. The deduction is to be allowed in the employer's accounting period which includes the close of the taxable year in which the employee recognizes the income. Where restricted property is not subject to the new rules governing recognition of income, existing rules regarding the amount of the deduc-

tion will continue to apply.

The committee provided with respect to nonexempt trusts that the employer will be allowed a deduction for his contribution at the time that the employee recognizes income, providing that separate accounts are maintained for each employee. Under present regulations, no deduction would ever be allowed by the Internal Revenue Service in those cases where the taxation of the income to the beneficiary of a nonexempt trust is deferred.

In general, where a parent company's or a shareholder's stock is used to compensate employees under a restricted stock plan, the transfer of the stock by the parent company or shareholder is to be treated as a capital contribution to the company which is to be entitled to a deduction in accordance with the re-

stricted property rules. The parent company or the shareholder merely is to reflect the contribution as an increase of the equity in the company which is entitled to the compensation deduction.

When property other than the employer company's own stock is given as compensation to an employee subject to a substantial restriction and the restrictions lapse at a later date, the company is required under existing law to recognize income in an amount by which the compensation deduction exceeds the company's basis in the property. Likewise, where the basis of the property exceeds the amount recognized as the compensation deduction, the employer can deduct this amount as a loss. The gain or loss would be reported in the employer's accounting period which includes the close of the taxable year in which the employee recog-

nizes the compensation income. The committee intends no change in these rules of existing law.

Effective date.--Generally, these rules are to apply to property transferred after June 30, 1969. The bill provides transitional rules, however, where the following situations are not to be subject to the new rules: (1) where property is transferred pursuant to a written contract entered into before April 22, 1969; (2) where the property is transferred upon the exercise of an option granted before April 22, 1969; or (3) where the property is transferred before May 1, 1970 (the House bill stated February 1, 1970), pursuant to a written plan adopted and approved before July 1, 1969.

APPENDIX G

APPENDIX G

May 5, 1993

Los Angeles Times

CAMPBELL LINKS

EXECUTIVE PAY TO

SHARE STAKE

• **Salaries:** CEO David Johnson, for example must hold three times his 1992 base pay in company stock by the end of 1994.

From Bloomberg Business News

NEW YORK--Campbell Soup said Tuesday that it is introducing a stock ownership plan for its chief executive and about 70 other senior executives that would link management income with shareholder returns.

Under the plan, David Johnson, president and CEO of the Camden, N.J.-based soup and packaged-food company, is required to hold three times his 1992 base

salary of $757,500 in shares by the end of 1994. He must maintain the three-times-earnings stake every year until he leaves the company.

"Campbell's new executive stock ownership standards emphasize that management and share-owner thinking are as one," Johnson said.

Executive or senior vice presidents are expected to buy and hold at least two times their annual base salary by 1994. Corporate vice presidents who have been with the company for three or more years will buy and hold the equivalent of one year's base salary. Senior executives will buy shares equal to at least half their annual salaries.

All corporate officers must hold at least 1,000 shares of Campbell stock by the end of this year.

Campbell's stock has fallen this year

along with other brand-name packaged goods, from a high of $45.125 on March 11 to $38.125 today in New York Stock Exchange trading.

Institutional investors have been pushing for companies to introduce plans like Campbell's, and a growing number of firms, including Eastman Kodak Co., Xerox Corp. and Chrysler Corp., now require or ask executives to own large stakes in the companies they run.

APPENDIX H

APPENDIX H

Two-Sentence Excerpt from Joint Exhibit 9-I, Page 11, Tax Court Trial in Mitchell.

Set forth below is the text of the two sentences in the above-mentioned joint exhibit on which the trial court relied in finding that the purchase of the warrant in 1973 by the petitioner represented a transfer of property in connection with the performance of services. To ensure that the excerpt will be seen in its context, the excerpt contains the three sentences which precede it in the proxy statement, and the sentence immediately following. The added material is italicized while the excerpt itself is not. This material is also found at Page 21 of the Petitioner's Opening Brief in this case in the Ninth Circuit.

The acquisition price of $9,300,000.00 was initially funded by cash, term borrowing and a short-term note. Early in 1973, the acquisition was refinanced through completion of the sale of the linen supply company and new term loans arranged with the Wells Fargo Bank. Contemporaneously with the placing of the new term loans, Mitchell purchased the Warrant for a cash purchase price of $103,500.00.

At the time of the refinancing the Board of Directors determined that in order to assimilate the business obtained from ITT Hamilton and continue the restructuring of the company begun in 1971 it was vital that Mitchell continue to

serve as the Chief Executive Officer of the Company, and that this would best be accomplished by his expectation of becoming a substantial equity holder in the relatively near future. In addition, the company's outside financial advisors, and potential investors approached with respect to the refinancing, were reluctant to finance or invest in the company unless it was apparent that Mitchell's continued association was, so far as possible, assured by his ownership of a substantial equity-type interest in the Company. *In an effort to insure that the terms of the Warrant were fair and equitable, the Board of Directors determined that the Warrant would contain provisions substan-*

tially identical to those found in a warrant for 51,000 shares issued to Wells Fargo Bank in connection with the refinancing.